



NATIONAL BANK OF UKRAINE BANKING SUPERVISION DEVELOPMENT PROJECT

FINAL REPORT EMERGING MARKETS SECTOR—OCTOBER 2005



Contractor:	BearingPoint LLC
Task Order:	PCE-I-00-99-00006-00, Task Order No. 827
Country:	Ukraine
Title of Task Order:	Banking Supervision Development Project
Reporting Period:	July 2, 2002 to September 2, 2005
USAID COTR:	Kornilova, Tatiana
USAID COTR Office:	USAID Mission Kiev, Ukraine
Strategic Objective:	1.3
Intermediate Result:	1.3.2

PREPARED BY PROJECT ADVISORY TEAM INCLUDING:
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WITH INFORMATION PROVIDED BY
SHORT-TERM EXPERTS UTILIZED ON THE PROJECT AND PREDECESSOR PROJECTS



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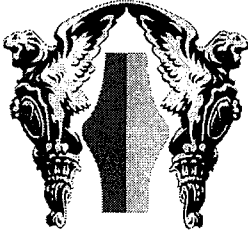
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With information provided by short-term experts utilized on the project and predecessor projects

October 2005

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Also Referencing Contracts:

Financial Sector Restructuring and Privatization Services in the ENI Region,
Ukraine Infrastructure Development, Bank Supervision,
Contract No. 121-C-00-98-00628-00
December 1, 1998 – June 30, 2002

Financial Infrastructure Development, Bank Supervision,
Contract No. EPE-I-95-00048-00
Task Order No. 13
December 1, 1998 – June 30, 2002

NIS Monetary Restructuring
National Bank of Ukraine, Institutional Support,
Contract No. CCN-0009-C-00-3147-00
Task Order No. 15
August 1, 1994 – March 31, 1997

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I. EXECUTIVE SUMMARY

This report summarizes the assistance by BearingPoint, LLC (BearingPoint) to the Banking Supervision Department (BSD), a department of the National Bank of Ukraine (NBU) as contracted and funded by the United States Agency for International Development (USAID). USAID has been providing assistance to the NBU since 1994. This Report covers primarily the time period applicable to this specific task order and phase of assistance, from July 2002 to September 2005.¹ We believe this project has contributed to an increase in the social and economic well being of Ukrainian citizens with a framework of democratic governance. Direct and indirect impacts of this project have helped the agriculture and small business sectors, as well increased the independence and stature of the NBU as a responsive and more communicative quasi-government body.²

The primary goal of this technical assistance can best be summarized as assisting the NBU to develop, modernize, and strengthen key banking supervision processes with a focus on risk-based supervision principles. The basic objectives of this project were threefold:

1. to evolve the basic BSD supervisory processes so that risk-based supervision becomes the basis for inspections, analysis and enforcement measures;
2. to improve the understanding and acceptance of risk-based supervision by the banking community; and
3. to encourage the BSD to implement an institutionalized program for training, career advancement and certification of bank supervision officials.

The cornerstone of BearingPoint's basic approach to technical assistance is to first understand the local banking environment and the individual country's supervisory and regulatory culture before attempting to apply international standards to that environment. Our advisors have viewed strategies and recommendations in the context of established goals and measures already taken by the Government of Ukraine, the NBU, and the BSD, and have been cognizant of the efforts undertaken by other international development organizations, working with them to assist Ukraine in achieving its goals. Our advisors are also keenly aware of the current trends in globalization, particularly in the area of financial services, and the need for international consistency in a rapidly consolidating and growing financial services sector. Our advisors have focused on international standards for banking supervision as set by the *Basel Committee on Banking Supervision (Core Principles)*, and on European Union (EU) Directives for the banking sector ("credit institutions," per EU terminology) and banking supervision. While many of the aspects of technical assistance, such as long hours of discussion with the client or research for the client, are difficult to measure, we believe the reader of this report will find considerable and measurable successes. In addition to our counterparts at the NBU, our advisors have also maintained an open and interactive relationship with USAID, other USAID contractors, other donor organizations such as the International Monetary Fund (IMF), the World Bank, and US Treasury, and the banking and business communities at large.

¹ The original task order was to KPMG Consulting, LLC, which has since been renamed to BearingPoint, LLC. Additionally, the subject task order was scheduled to be complete by July 2, 2005. BearingPoint received a 60-day, no-cost extension on June 16 2005, which changed the project end date to September 2, 2005.

² The NBU is an independent financial institution, yet the President of Ukraine appoints its Chairman. While we did not see any obvious political influence on the operations of the NBU, we did experience political interference with respect to modern reform initiatives.

Through the efforts of USAID's banking supervision development project, the NBU has declared its intent to upgrade its bank supervision practice and to introduce a risk-based supervision approach. This endeavor required a substantive policy development component and involves a significant cultural change in the process of banking supervision. The following highlights our most significant success stories over the duration of the current task order.

- We have assisted the NBU with delivery of twenty-one (21) risk-based seminars for more than 500 banking supervisors, covering nearly all regions of Ukraine. At each of the regions with large commercial bank presence, USAID advisors and NBU staff met with commercial bankers to discuss the risk management recommendations in detail. We also organized and led eight roundtable discussions of risk management in the banking industry with commercial bankers representing more than 85% of the total of banking assets in Ukraine. As a result of this assistance, banking supervisors are better able to identify excessive risks in banks, design supervisory strategies based on observed risks, and be a positive force for improvement of commercial bank's risk management systems. Commercial bankers have also improved their approaches to, and respect for, risk management.
- BearingPoint advisors developed and delivered a comprehensive, two-week course on risk-based supervision in order to build sustainability of risk-based supervision goals. We delivered this course to more than twenty (20) supervisors in November 2003. As a result, these trained advisors are now being used as integral parts of the risk-based supervision seminars mentioned above.
- BearingPoint advisors developed and delivered a half-day, risk-based supervision case study to the NBU's most senior management members (Acting Governor, and all Deputy Governors) and BSD senior management (all Directors). Certain members of the NBU's senior management were skeptical of the subjectivity of risk-based supervision prior to this case study; however, many indicated they saw risk-based supervision in a new and positive light after this exercise. As a result, we obtained senior management's support for our project's goals, which further improved the sustainability of these goals and ideals.
- BearingPoint advisors coordinated and participated in a four-day seminar delivered by representatives of the General Inspectorate of Banking Supervision from the National Bank of Poland (NBP). The seminar covered the topics of risk-based supervision in Poland, a detailed assessment of credit risk monitoring and assessment tools, and the examiner accreditation process used by the NBP. As a result, we have been the catalyst for establishing long-term relationships between a peer EU country and Ukraine, which will have benefits lasting well beyond our technical assistance project.
- We have assisted the NBU senior management with development of many critical documents, following international standards and practices for banking industry and banking supervision development. A few of the more significant research and development papers include: development of the banking system in Ukraine, policy recommendations for risk management systems, action plans for implementation of risk-based supervision, and risk assessment of commercial banks. As a result, the NBU has moved closer to consistency with the Basel Core Principles for Effective Banking Supervision and European Union Directives in the banking sector.

As a result of this technical assistance, the NBU now is well positioned to deal with existing challenges and meet the future ones. The NBU's trend of increasing levels of compliance with the Basel *Core*

Principles is the best evidence for this conclusion. We believe this result is sustainable. We managed not only to prepare documents and regulations, but also to ensure that these regulations became the product of the BSD, rather than just a handbook brought by an advisory team. We can be particularly proud of very effective training programs aimed at rank and file supervisors. The performance cannot be measured simply by how many people we have trained (although these numbers are quite impressive); the most important part of any training program in bank supervision is ensuring that the counterparts can continue to train themselves. For the first time over last decade working with the NBU, we managed to ensure a core cadre of well-experienced people to take the lead in future training efforts. This outcome is even more important in light of the perpetual organizational changes at the NBU and BSD, which create almost constant training needs.

Elaborating on the foregoing, this report will discuss the tangible results and benchmarks as set forth by USAID Mission, viewed in an historical context. First, we provide a brief overview of the Ukrainian economy and banking sector, and discuss the major global and regional risks and trends facing the Ukrainian banking industry and the NBU today. Based on this information, we then identify key areas in which we believe that future technical assistance is needed in order to build upon the positive results achieved over the past decade. We then provide a brief historical summary of the development of USAID assistance to the NBU in general, and the BSD in particular, since 1994, followed by a detailed summary of our accomplishments under the current task order, including lessons learned.

We would like to emphasize that the successes of this project are largely due to the dedication of several persons inside the NBU. We were consistently supported by NBU Chairman Tyhypko and by his successor Acting Chairman Yatseniuk in the concept of risk-based supervision and in our efforts to achieve better abilities to conduct effective consolidated supervision of financial groups. Most notably, however, we need to recognize Mrs. Natalia Ivanenko, Mrs. Svitlana Faber, and Mrs. Iryna Pozharska, who were our daily counterparts in this effort. Their support of our project's goals and active use of USAID technical assistance has been the primary cause for any successes we have achieved. We would also like to acknowledge our partners at USAID who have been consistent, committed, and patient throughout the various phases of this effort. Although the road to success might not have always been straight or smooth, the underlying direction and principles of assistance have been consistent.

II. BANKING SUPERVISION AND BANKING INDUSTRY DEVELOPMENTS

A. Macroeconomic Overview

The Ukrainian economy has been performing very well over the past four years, in the aftermath of the 1997-8 global financial crisis. The economy's real GDP figures fell by 1.9% and 0.2% in 1998 and 1999, respectively. Since 2001, the Ukrainian economy has posted positive year-on-year GDP figures, averaging approximately 9% per annum.³ This growth can be attributed to favorable economic conditions for Ukrainian exporters and growth of investments in the country, coupled with steady rises in consumer demand, particularly in the construction sector. Inflation has been relatively modest, at roughly 6-7% over the past four years.⁴ The local currency (the Hryvnia), has been stable throughout this period as well, except for the brief disruptions during the "Orange Revolution" in 2004. The average wage of Ukrainian workers has risen steadily over the past four years, averaging nearly 17% year on year. With the improvement in the economy over the past several years, and the generally positive changes in the government, Ukraine's sovereign debt ratings are slowly improving. This means that the government and the major banks are able to borrow for longer terms to maturity and cheaper costs. This should translate to lower borrowing costs for businesses in Ukraine and more stability to the banking system.

B. Banking Industry Development and Risks

The banking industry in Ukraine has undergone significant changes in recent years. Ukraine continues to have a high number of commercial banks. Ukraine has 180 "registered" banks, with 160 operating. Nineteen of these banks have foreign capital, with seven being 100% foreign controlled. In the future, we expect that the overall number of banks will fall due to competitive pressures and, to a lesser extent, a some additional license revocations. The number of banks with foreign participation will likely rise, as more trust and transparency becomes evident in the Ukrainian economy. Also, the largest banks in Ukraine are already in need of foreign capital to maintain extremely high growth rates.⁵ The entrance of more foreign capital will be a positive development for Ukraine, bringing better products and services, increased risk hedging opportunities, and stronger risk management systems. The growth of assets in the Ukrainian banking system deserves attention since privatization of the banking industry did not, in most cases, produce a desired effect of improved governance. Weak governance, coupled with rapid growth in total assets, particularly rapid growth of long-term, foreign currency loans, is a dangerous combination for the financial sector risk profile. Our project has successfully assisted the NBU to force certain risk management improvements in Ukrainian banks, yet much work from the public and private sectors remains to be done in this area.

The total assets of commercial banks showed a remarkable growth rate in recent years, growing from less than 40 billion Hryvnia in 2001 (US\$ 8 billion) to 141 billion (US\$ 28 billion) at year-end 2004. Commercial banks have been successful in attracting deposits, particularly individual deposits, over the past several years. Total deposits to GDP totalled nearly 25% as of year-end 2004, up from only 5% in

³ Ukraine's real year-on-year GDP figures are the following: 2001 – 9.8%; 2002 – 5.2%; 2003 – 9.6%, and 2004 – 12.1%. It is widely acknowledged that the 12.1% figure for 2004 was distorted by the outgoing government to show higher economic growth. While not scientific, it might be wise to average 2004 and 2005 GDP to approximate a more realistic figure for this period.

⁴ Inflation nearly doubled to 12.3% in 2004 from less than 6% in 2003. We do not believe this is part of a longer-term trend, rather we believe this is an aberration due to the political maneuvering by the former government in run-up to the 2004 election.

⁵ As a subsequent event, one of the largest banks in Ukraine reached an agreement in principle to be acquired by Austria's Raiffeisenbank. The deal is scheduled to be consummated in late 2005.

2001. A ratio of 50% is generally considered typical for an advanced economy. Banking industry registered capital has also increased from US\$ 1 billion to US\$ 3.5 billion over this same time period. The financial sector in Ukraine is skewed towards banking, with the securities industry, pension funds and insurance companies remaining in their infancy. The top ten banks in Ukraine control over 50% of the assets. The commercial banks in Ukraine have been successful in accessing international capital markets over the past several years. This speaks highly of the increasing trust and transparency in the banking sector. However, there are certain risks with concentrations of foreign funding through loan syndications and Eurobonds that must be recognized. Primarily, the maturity of the obtained syndications and bonds is often less than the duration of the bank's loan portfolios. While the banking industry is inherently illiquid, concentrations of funding tend to amplify this liquidity risk. Also, when funding comes to a bank in a large block, particularly through loan syndications, the bank is under tremendous pressure to put this money to work in the form of loans as quickly as possible. This may push the bank to lower its credit standards in the short-term and make loans that it otherwise would not have made if the funding had come over time from steady deposit growth. Banks are moving rapidly, from a miniscule starting point, into more small and medium-sized business lending, and more consumer credit. Managing credit risk is more difficult with small and medium-sized businesses, because the borrowers are generally unknown, may not have a history of credit, and often lack financial sophistication that is generally expected of larger borrowers. This makes underwriting efforts much more difficult.

Certain banking sector profitability ratios will likely decline in the near term. Due to an expected higher level of competition in the financial industry, the cost of funds for banks will likely not decrease as fast as asset yields. In addition, the necessary improvements in risk management systems and information technology (see below) will also put pressure on profitability. This might place pressure on "return on assets" figures for profitability. However, because the overall level of capital, in comparison with assets, is declining, we can expect more stability, if not improvements, in "return on equity" measures.

Banking customers in Ukraine are rapidly learning the principles of customer service and are choosing banks that provide the best service. We expect that banks will continue lowering their lending and general deposit rates in 2005/6, particularly to larger clients established credit histories, and the net interest margin for banks will slowly decline.⁶ Small business without credit histories might not see this reduction for some time ahead, simply due to the high administrative expense associated with these borrowers. To make up for interest margin declines, banks may begin to turn to loan customers in higher risk categories to increase interest income and may also aggressively seek out portfolio increases or new loan products in higher-yielding consumer lending products such as car loans and credit cards. Further declines in interest rates will also make room for longer term lending such as residential mortgage lending. Longer term lending will increase the amount of interest rate risk in the banking system, as the average maturity of a loan becomes much longer than the average maturity of a deposit. Increasing mortgage lending will introduce new operational risks to the banking industry that have not been witnessed to date. Outside of the loan portfolio, banks may also turn to new investment products, other than Ukrainian government bonds, to increase interest income from the investment portfolio. The advent of new financial instruments in Ukraine will add desperately needed new, but yet untested, investment products to the financial sector as a whole. New financial instruments, including more sophisticated hedging instruments, are not only critical to the banking system but also mandatory for growth in the nascent private pension sector.

Also impacting earnings performance is the area of information technology. We believe that information technology risk could be second only to credit risk in Ukrainian banks. Many banks have not made proper investments in technology over the past several years of rapid asset growth. This has resulted in

⁶ We can already see a dramatic decline in interest margin for domestic currency operations.

banks operating in a decentralized server environment, rather than with a mainframe system. The basic cause of the problems with risk management of information technology appears to be that commercial banks have: 1) decentralized the information technology area, making information technology decisions a departmental issue rather than a bank-wide issue; and 2) have included information technology costs as part of an annual budgeting process rather than part of their longer-term strategic plan. We also believe that the external audit and internal audit functions for commercial banks need improvement in scope and depth of reviews relative to information technology.

Electronic banking will also become an increasingly higher risk in the banking industry. The Internet has brought new strategic challenges for the banking industry to deal with. From a strategic risk viewpoint, every bank will need an Internet strategy. This includes small and large banks, although obvious differences in strategy will reflect the size and complexity of operations for each bank. From an operational risk viewpoint, each bank must address the issues of accuracy and security with electronic banking transactions. Electronic banking allows rapid, high volume transactions to occur easily. As seen recently, this increases the ability and ease of the criminal element to launder money, even in developed countries.

C. Banking Supervision Developments and Future Risks

Since USAID began its technical assistance in the mid-1990s, the NBU has made significant progress in establishing a bank supervision regime consistent with *Basel Core Principles for Effective Banking Supervision (Core Principles)* and international best practices. The bank supervision function within the NBU has elevated its status over the last decade. Now, the function is one of the largest areas of the NBU in terms of the number of personnel. Since May 2005 the structure of bank supervision function is as follows:

- In the NBU's Head Office there are four Departments:
 - (1) Bank Supervision Policy Department lead by Mrs. Ivanenko;
 - (2) Offsite and Onsite Department lead by Mr. Zinchenko;
 - (3) Registration and Licensing Department lead by Mr. Parkhomenko; and
 - (4) Bank Liquidation Department lead by Mr. Rayevsky.

The Policy Department sets forth bank supervision regulations and policies, while the three last Department operate as functional departments for largest banks.

- Each of the twenty-five (25) NBU Regional Offices has a banking supervision function that operates as a functional area for regional banks and their affiliates.

These four departments and regional offices represent the bank supervision function, the BSD. A Deputy Governor in Charge of Supervision, Mr. Krotiyuk, is the most senior NBU official who deals with bank supervision matters. One of the most challenging issues for the project was the on-going structural reform of the NBU and, more importantly, the BSD. In particular, during the tenure of this project, the BSD went through four organizational reforms. In many cases, we saw no explicit need to make such dramatic organizational changes since many of them were triggered by individual preferences of NBU senior management. Plus, an organizational change that is not supported by a longer-term strategy can (and does in many cases) lead to unclear distribution of powers and responsibilities. As a result, many important and knowledgeable counterparts changed their offices and positions, often slowing our momentum for reform. The overall strategy of the advisors was to maintain open communications with both "individuals" and "positions." This proved to be a successful strategy, although not always optimal.

The overall capacity of the BSD to perform risk-based supervision and take action when risks are deemed excessive continues to develop. Several improvements have been made in compliance with the *Core Principles*.⁷ The NBU has implemented basic supervisory systems and is in the process of implementing more advanced supervisory processes that would move it closer toward full compliance with international standards. As this assessment of compliance with the *Core Principles* shows, there are a number of areas where process implementation is not yet complete, or where laws and regulations need modification. In addition, there are several areas that are not sufficiently covered by supervisory practices. A summary of the ratings, and the comparison of Ukraine to international benchmarks, is set forth below:

Category	NBU/BSO	International Benchmark*
Fully Compliant	2 (8%)	35%
Largely Compliant	15 (60%)	33%
Materially Non-Compliant	8 (32%)	24%
Non-Compliant	0	8%

* Source: 2004 summary of the assessments of 78 countries reviewed by the IMF/WB

As the above table demonstrates, Ukraine is roughly consistent with the global average. While it is significantly below the international benchmark in the top (fully compliant) category, its combined percentages of “fully compliant” and “largely compliant” ratings (68%) are identical to the international benchmarks in these areas. Likewise, Ukraine’s combined ratings in the “materially non-compliant” and “non-compliant” categories are identical to the international average (32%), while Ukraine has no ratings in the “non-compliant” category.

In the most recent assessment, we saw three issues that greatly impacted several rating categories. These were the transparency of ownership, corporate governance and consolidated supervision. All three areas require changes to the Law on Banks and Banking Activity (Banking Law) and our advisors have drafted proposed amendments for all three areas. There are also several other areas where, based on experience, amendments to the Banking Law or NBU regulations are required. One of the most important areas is capital. The NBU needs the clear authority to set capital requirements for all banks above the legal minimum, and to set individual capital requirements above the minimum for individual banks that are considered higher risk. The NBU needs this authority to properly implement risk based supervision and the capital standards in the Basel II Accord. Other necessary revisions to the Banking Law that are needed include authority to share all bank supervision information including inspection results with the Ministry of Finance (for Anti-Money Laundering purposes) and foreign bank supervisors for both home and host country banks. In the area of insider lending, the NBU needs to be given the authority to require detailed reporting of all insider transactions. In addition, the Banking Law needs to be amended to preclude favorable rates on insider transactions. The Banking Law and the NBU Regulation on Investments need to be changed to clarify misinterpretation of the law, which was intended to require NBU approval of significant or non-bank investments by banks. Finally, the restriction on inspection of new banks for the first 12 months of operation in the Banking Law needs to be eliminated. The NBU should have full authority to inspect any bank whenever it deems it is necessary. In particular, new banks tend to carry more risk and should be examined during their first six months of operation.

BSD staffing and training continue to be areas that require management’s attention. It was noted during the review that banks are not being inspected as frequently as required by NBU policy. Although overall bank supervision staffing levels that have been approved appear to be reasonable, bank supervision has not been fully staffed for a significant period of time. In addition, turnover continues to be high despite

⁷ Please see Appendix A to this report for a more complete overview of compliance with the *Core Principles*.

improvement in salaries and travel reimbursement. A review of staffing obstacles should be conducted and a plan developed to reach and maintain full staffing levels. The plan should ensure that resources are assigned based on risk in accordance with national priorities. Efforts should be made to eliminate duplication and streamline processes wherever possible. Currently, only minimal reliance is placed on the work of internal and external audits. Continued improvements in this area could eliminate come duplication of inspection focus on internal controls and improve banking supervision efficiency. A program to strengthen both of these areas should be undertaken with the goal of placing more reliance on these systems once they are considered satisfactory. In the long term relying on the work of others (where competent) will take some pressure off of the bank supervision resources.

As mentioned above, training has been given priority over the last 18 months. The bank supervision staff has been introduced to the Risk Assessment System (RAS) and the concepts of risk based supervision. Training needs to continue to be a priority to increase the level of knowledge of the various risk components and bank risk management systems. Training in these areas, particularly as it relates to credit risk management systems, is also critical to future implementation the Basel II capital calculation framework. Knowledge and procedures for the assessment of market risk and operation risk also require further development and are areas that should be given priority in training. High turnover increases the training needs to develop the knowledge and skills necessary for a qualified supervision staff. The cooperation and coordination between the BSD and the Personnel Department has also greatly improved. Continued efforts to further expand the formal training program are needed.

D. The Effects of the “Orange Revolution” on our Project

Ukraine’s “Orange Revolution” brought many positive changes to the country’s government structure and attitude, and should be the start of a more promising future for the Ukrainian people. However, the short-term effects of the revolution were highly disruptive to the BSD and our project.⁸ We saw the beginning of a slow-down in reform activity during the summer of 2004, as presidential elections loomed. Legislative reforms stopped in full at this time. In addition, Governor Tyhypko, took personal leave from the NBU to become campaign manager for the presidential candidate Mr. Yanukovich. The NBU Governor had, to that point, been highly supportive of our efforts and seemed to have a keen insight on the banking sector from his background as a commercial banker in the country’s largest bank. The First Deputy Governor, Mr. Yatseniuk, become the Acting Governor of the NBU during Mr. Tyhypko’s absence. Mr. Yatseniuk was not a believer in certain critical reforms related to risk-based supervision, and seemed to be a proponent of more compliance-based initiatives. This forced our advisors to turn their attention to regaining the support that had been previously earned, and we were successful in this effort. After several discussions and a development of a specialized risk-based supervision case study for senior management, Mr. Yatseniuk also became a proponent of our efforts.

In the immediate aftermath of the revolution, we lost several key counterparts with whom we had invested considerable time in bringing about the cultural change necessary for risk-based supervision implementation. Among the counterparts our project lost were the NBU Governor, the First Deputy Governor, the Deputy Governor in charge of banking supervision activity, and the Director of the BSD. As a result of these changes, our project lost certain momentum necessary for effective and sustained change in culture and processes. A new Governor of the NBU, Mr. Stelmakh, was nominated in early 2005. Logically, in the aftermath of a banking sector crisis, the main goal in the early portion of Mr. Stelmakh’s tenure seemed to shift to providing banking sector “stability” rather than implementing banking sector “reforms.” In addition, Mr. Stelmakh instigated a further restructuring of the BSD and its

⁸ Please see Appendix B to this report for a brief overview of the banking sector situation during the Orange Revolution time period.

supervisory processes, again seeming to regress towards compliance-based supervision. The appointment of Mr. Krotiyuk as the new Deputy Governor in charge of banking supervision eventually restored the support for risk-based supervision implementation.

E. Recommendations for Future Technical Assistance to the NBU and the Banking Industry

We have developed several issues for a medium-term strategy of the NBU, assuming a reform-minded government and Governor of the NBU.

1. Implement Basel II for the banking sector, including capital adequacy modeling and transparency requirements. Along lines prescribed in Basel II, improve understanding and implementation of corporate governance and risk management techniques for commercial banks through intensive training.
2. Conduct bank financial statement analysis training for private sector financial analysts and journalists to encourage proper usage of more transparent financial statements.
3. Assist an existing, or create a new, independent credit rating agency (similar to Moody's or Standard and Poor's) that is focused on medium-sized businesses, with a long-term goal of achieving minimum standards for a rating agency as listed in Basel II.
4. Persuade the banking industry and the relevant government bodies of the benefits of foreign capital participation in the banking industry and the financial sector as a whole, and develop a plan to remove unnecessary barriers to entry.
5. Facilitate creation of new financial instruments in the capital markets.
6. Modernize the State Commission for Regulation of Financial Services Markets, particularly in the area of asset management of pension funds.
7. Assist the NBU with monetary policy modernization, including a change from currency stability to inflation monitoring and targeting.
8. Convince the banking industry to create a functioning credit bureau, as a method of improving small business and consumer lending.

Each of these points is discussed in more detail below.

1. Implement Basel II

USAID should continue training for the banking sector, including people from the NBU, on risk management techniques. The main focus should be on the following topics:

- duties and responsibilities of the supervisory board, bank organizational structure for risk management and internal audit;
- managing credit risk;
- risk ratings for loan portfolios to match international rating agencies;
- asset and liability management techniques;
- capital adequacy calculation models; and
- transparency of bank financial statements.

We recommend that training be offered to the banking sector and NBU together, not as separate audiences. They need to understand each other's role in the sector more deeply. USAID should continue to assist with the legal aspects of corporate governance, risk management, transparency and consolidated supervision techniques of banking and financial industrial groups through future projects.

This training could be completed under the heading of implementation of Basel II for the banking sector, including capital adequacy models and transparency. A stronger movement toward international standards, transparency of the financial sector, and openness to foreign capital participation, are critical to future development of the banking sector. This might be a critical time to achieve success in this area. We have seen the benefits of outreach to banks during our focus on risk management and the risk assessment system this year.

One of the first objectives in the NBU move toward Basel II consistency should be organization of accounting data. Basel II is quite specific about the organization of the asset side of a bank's balance sheet, including various data sets that are required to begin collecting data necessary for consistency with Basel II. If the banks change their chart of accounts, the General Department of Banking Supervision (GDBS) will also need to change the format of the banks' financial report and the management information systems that use the financial report data. We would also suggest taking the time to obtain feedback from all departments in the NBU on any financial report data so that all information needs of the NBU can be collected from one source. The NBU should present the complexities of Basel II to the banking industry and obtain feedback from the banks on this process. We would estimate that the process of changing the banks' chart of accounts and the financial report would consume two years.

Basel II has considerable useful information regarding corporate governance and risk management concepts, particularly with regard to credit risk. The GDBS should incorporate this information into the RAS. The GDBS should also begin analyzing the asset classification and provisioning regulation for consistency with these same principles, and to begin the "risk mapping" process to the five asset classification categories mentioned in Basel II (strong, good, satisfactory, weak and default). The GDBS should begin developing amendments to the capital calculation normative for market risks. This amendment may not be an urgent task, as market risks are not particularly high-risk areas in the banking system as a whole at this time.

One new aspect of the Basel capital calculation that deserves a heightened level of attention is the area of operational risk, particularly technology risk. Banks in this region tend to view technology as part of a short-term annual budget, and not part of a long-term strategic plan. This short-term focus has led to banks' operating in a server environment, when they should be thinking of a mainframe. Also, many banks use internal programmers to cut costs of purchasing software. While internal programmers do reduce short-term costs, the long-term expenses of poor programming or undocumented programs could be significantly higher. The GSBS needs procedures on reviewing information technology risks in banks, and bankers and auditors needs training on how to manage these risks.

2. Train Financial Analysts and Journalists

The banking system in Ukraine needs to supply much more information to the general public. However, supplying additional financial information and improving transparency assumes that the public, or at least financial analysts and journalists, know how to read and analyze this new information. As transparency rules take hold, USAID should also offer training for financial analysts and journalists on how to interpret financial statements. The NBU wants to encourage investors to ask questions and provide better analysis of the banks for the public view.

3. Create Independent Credit Rating Agencies

Under the topic of transparency, USAID should assist (or create) rating agencies with a long-term goal of achieving minimum standards for a rating agency as listed in Basel II. The strategy of the rating agency is not to compete with the international service providers such as Standard and Poor's, Moody's, and

Fitch, but to address the medium-sized businesses of Ukraine who might consider the international providers too expensive to justify. An independent source of ratings would facilitate these companies obtaining credit.

4. Persuade Relevant Market Participants of Benefits of Foreign Capital Participation

As stated above, transparency of the financial sector, and openness to foreign capital participation, are critical to future development of the banking sector. USAID should strongly support the concept of increased foreign capital entry to the banking sector in Ukraine. Foreign bank entry has several positive effects, including:

- a decrease in the overall cost of funds in the banking system, as banks can borrow from parent companies cheaper, which will reduce the necessity to compete for high-rate deposits and yield-chasing customers;
- a “down-market” move by local banks to service more small and medium enterprises, as they can no longer compete for many large companies’ business due to limited products and services and higher cost of funds -- the foreign bank’s lower cost of funds also helps the general economy as large companies can borrow for less while spreads are maintained;
- an increased number of products and services available to consumers, as local banks will need to compete with the foreign banks; and,
- better risk sensitive lending and loan pricing by the foreign banks in the local market.

Admittedly, the country’s attitude toward foreign bank entry has softened over the recent years. Commercial banks are becoming more open to the idea of foreign strategic investors, but remain hesitant to embrace the idea of foreign bank control. Many of the obstacles to foreign bank entry continue to rest with various reform initiatives such as: creditor rights, collateral laws, registration of liens, and corrupt tax administrations. USAID should support a new government’s efforts to resolve these problematic issues.

5. Facilitate Development of New Financial Instruments

USAID should facilitate the creation of new financial instruments for hedging and speculation, including corporate bonds, municipal bonds, mortgage-backed securities, and basic derivative products (currency forwards and possibly interest rate swaps).

6. Modernize the State Commission for Regulation of Financial Services Markets

USAID should assist the State Commission for Regulation of Financial Services Markets, particularly in the area of asset management of pension funds. The Commission needs considerable assistance in strategy, organization structure, and training of personnel. The Commission is roughly at the stage of the NBU ten years ago. The pending expansion of pension funds in Ukraine will place an extraordinary burden on the Commission’s very young and inexperienced staff. The government might wish to explore more avenues of cooperation with the Commission, or possible creation of a unified regulator, if banks, assets managers of pension funds and insurance companies form increasingly close links.

7. Assist the National Bank to Move Toward Inflation Targeting in Monetary Policy

USAID should assist the NBU with monetary policy modernization, including a change from currency stability and a managed floating exchange rate system to an inflation-targeting system. The NBU will have to continuously monitor a wide range of indicators, including asset prices, to avoid slippages in

maintaining domestic price stability. These changes will necessitate a review of monetary policy processes and models necessary to monitor the financial sector. Specifically, the NBU needs policy advice from experienced professionals in this field, particularly professionals with expertise in modeling, to improve the NBU's capacity to conduct monetary policy. Related to this topic and the topic of financial instruments above, the NBU should revisit existing foreign exchange controls to allow more Eurobond issuance possibilities. The current foreign exchange controls were developed at a far different period of time, and may now be outdated.

In the short-term, the NBU should consider floating the Hryvnia to a basket of currencies based on trade receipts (US Dollar, Euro and Ruble) rather than strictly to the US Dollar. Currently, the Hryvnia is fixed against the US Dollar, but fluctuates against the Euro and Ruble. This float against the US Dollar has confused the general public, as appreciation of the Euro against the Hryvnia is viewed as a weakness in the Hryvnia, not a strengthening of the Euro. This is a subtle point, yet it does have an effect on public confidence and currency stability.

8. Assist With the Creation of a Credit Bureau

USAID should support development of a functioning credit bureau. We believe this is already envisioned in the "Access to Credit" program. This also assists the banking sector with risk management, particularly with small business and consumer lending.

III. HISTORY AND PURPOSE OF USAID BANKING SUPERVISION ASSISTANCE TO THE NBU

A. Overview

This project represents a continuation of BearingPoint's technical assistance, under USAID auspices, to the NBU, which has been ongoing since April 1995. In total, four task orders have been awarded to BearingPoint specifically to provide assistance to the NBU. There has been an ongoing BearingPoint presence, using a combination of resident and short-term advisors, as well as local expert staff, since the inception of the USAID assistance program.

The first USAID project that included the NBU was the "Banking Training Project" (1994 – 1999). It allowed the NBU to expose a significant number of its employees to up-to-date training courses, both elementary and advanced. A second USAID project, part of the NIS Monetary Restructuring Project (1994 – 1997), was specific to the NBU, concentrating on strengthening its macro-economic and monetary policy functions. That project also included a banking supervision component. Projects focusing explicitly on the development of the NBU's banking supervision function began in 1997 and lasted through the conclusion of the current task order. During this period, the NBU's BSD evolved from its former "revision" or compliance function in the head office alone to a more modern, risk-based function that is more adept to cope with present challenges.

From an historical perspective, we can segregate the following stages of the NBU and BSD development (which in many cases overlap across two or more USAID task orders):

1. **Establishment of Basic Supervision Tools** (1995 – 1997). Within these two years the USAID advisors developed an Onsite Manual, Licensing Policy and Offsite Handbook, and provided intensive training to bank supervisors, especially on-site examiners. Also at this stage, the CAMEL Policy was drafted.
2. **Accounting Reform** (1996 – 1998). Although accounting reform was not an explicit part of the scope of work for banking supervision task orders, the USAID banking supervision advisors made a major contribution to this effort. Introduction of International Accounting Standards (IAS) has brought the NBU and Ukraine's banking system much closer to compliance with international best practices. Assets valuation policies were introduced that allowed to fully implement Basel 1988 Capital Accord. Accounting reform was also a start of more open and client-oriented banking system since new format of banks' financial statements, allowing the general public and foreign investors to better understand their position and performance.
3. **Financial Crisis Recovery** (1998 – 1999). Following the August 1998 financial crisis in the Russian Federation that also had affected Ukraine, the NBU and BSD, supported by USAID advisors and other donors, spent quite significant efforts in assessing Ukraine's banking system vulnerability. The advisory efforts were concentrated on macro issues, e.g. how to overcome fragmentation and fragility of the banking system, as well on how to re-establish public trust.
4. **Legal Reform** (1998-2005). When USAID commenced its assistance to the NBU in 1995, Ukraine was operating under a banking law that had been written in 1991, immediately following independence in the wake of the collapse of the Soviet Union. The 1991 law provided only a skeletal legal framework for banking regulation and supervision, and left virtually no room for the exercise of supervisory judgment, a critical component of risk-based supervision. BearingPoint advisors worked extensively with the NBU BSD and Legal Department during

1998-99 to develop a draft banking law which included many concepts based on EU and Basel Committee principles. Subsequent to the submission of the draft law to the Verkhovna Rada (Parliament) in mid 1999, BearingPoint advisors worked with NBU representatives and the Rada's Finance and Banking Committee during 1999-2000 to fine-tune the draft and prepare it for consideration by the full Rada. The new Banking Law became effective in January 2001. While the law needs updating and improvement in certain areas, it represents a major step forward in the development of a modern bank supervisory regime. Subsequent to the enactment of the Banking Law in 2001, our advisors worked with the NBU to write regulations to implement the law, and to identify areas where the law should be improved.

5. **Problem Bank Issues (1997 – 2001).** One of the major focuses of USAID assistance has been the development of policies and procedures to deal with problem banks. This area was the most difficult in which to gain counterpart support at first, and in turn, implementation of revised supervisory standards. The advisors initially detected a great deal of reluctance by the NBU counterparts to proactively deal with such sensitive issues as insider abuse, weak credit standards, poor accounting systems and finally, weak management teams. The NBU did not have a history of directly addressing problem bank situations, but rather utilized indirect approaches through the administration of “rehabilitation plans,” which were essentially a stratified budgeting process that focused on cutting overhead expenses. To address this situation, BearingPoint legal and regulatory advisors worked closely with the NBU Legal Department and Bank Resolution Unit (BRU) to improve the framework for supervisory actions on banks. This process began by revising NBU Regulation 115, which was the original document for placing banks under financial rehabilitation plans. Over the course of these projects, Regulation 115 evolved into a better structured legal enforcement document entitled Regulation 215, “On applying enforcement measures to banks and other financial and credit institutions by the National Bank of Ukraine for violating the banking legislation.”
6. **Advanced Supervision Tools Development (1999 – 2003).** These years of economic recession were devoted to elaboration of more sophisticated supervision tools. Most important were Uniform Bank Performance Report (UBPR) and Bank Dossier System, which are still being used by the NBU. The UBPR is a comprehensive set of ratios derived from a bank's financial reports that allows off-site analysts to view certain trends in a bank's financial condition. The Bank Dossier System provides an electronic file folder of supervisory information on each bank. Also at this time, most asset valuation rules were revisited based on accumulated practice that led towards more conservative estimation of banking capital. A notion of prudential supervision was introduced and communicated to NBU senior management.
7. **Risk-Based Supervision Implementation (2003 – 2005).** By 2003 it was obvious that Ukraine had a unique situation compared to its western neighbors: a remarkably low share of foreign banks and investors, poor corporate governance and weak transparency. It was clear that while the NBU's capacities were adequate to deal with domestic banks and their challenges, they were not sufficient to meet the challenges brought by foreign banks entering the market. In addition, the bubble-type growth of most domestic banks was a worrisome indicator for both the Ukrainian government and international agencies, which started to question the appropriateness of compliance-based supervision. A concept of risk-based supervision was introduced and supported by major policy development and training efforts.

A closer look at the history of USAID assistance to the NBU in the banking supervision area, and a summary of BearingPoint's role in these efforts, are presented below

B. Summary of Previous USAID Bank Supervision Assistance to the NBU

1. NIS Monetary Restructuring Project Highlights (April 1995 – March 1997)

The banking supervision component of this project commenced in March 1995, with an amendment to the original (July 1994) task order, which had focused on the goal of promoting sound monetary and fiscal policy. The March 1995 amendment added the banking supervision component as a two-stage program based on current bottlenecks in: 1) the legal and regulatory structure; and 2) the accounting system. Subsequently, the task order was amended two more times, in May and September 1995, to provide additional focus on onsite and offsite examination issues, NBU enforcement capability, and problem banks.

Beginning in April 1995 and throughout this project, BearingPoint advisors contributed to an on-going dialogue on the adequacy of legal and regulatory initiatives to strengthen banking supervision, and worked closely with the World Bank and IMF in defining necessary reform initiatives. The advisors proposed to the NBU Governor and Board of Directors a strategy for the actions necessary to integrate the components of a supervisory program into one that would result in a complete strategy for individual banks and for the banking system. This proposal was accepted and worked on throughout the project.

The advisors also supported the Deputy Governor for bank supervision by preparing a position paper on the necessity of maintaining the BSD within the NBU and of maintaining its independence from political interference.

In pursuit of these goals, the advisors developed an on-site banking supervision manual, containing 15 chapters of procedural tools, and provided a training program in a series of 5 seminars on implementation of the new manual.

The advisors recommended, and assisted with the successful implementation of, changes in the organizational structure of the BSD, and recommended a format for a weekly meeting of the BSD section chiefs with the Director, attended by the technical advisors.

The advisors assisted the NBU's accounting reform unit in preparing a draft series of 20 financial reports for use by commercial banks once they had converted to an IAS-based chart of accounts, and assisted the NBU in significantly overhauling its prudential regulations, including the definition of regulatory capital, risk weighted assets, and insider lending.

In connection with the problem bank function, the BearingPoint advisors assisted with the creation of the BRU, and helped to develop a supervisory profile on 8 pilot banks, followed by the development and implementation of remedial action plans for 2 of these banks (including a "cease-and-desist" order for one of the banks) based on preliminary CAMEL ratings. They also delivered a week-long training seminar on restructuring and rehabilitation of problem banks, and drafted a liquidation manual in cooperation with advisors from Ernst & Young.

BearingPoint advisors also assisted the NBU and advisors from the Financial Services Volunteer Corps (FSVC) in developing new licensing procedures.

2. Financial Infrastructure Project Highlights (April 1997 – November 1998)

During the term of this project, BearingPoint provided resident experts in the areas of senior policy advice, bank supervision and legal and regulatory reform.

The senior policy advisor focused significant time on the development of a strategic plan for bank supervision. The development of this plan was predicated upon the NBU meeting certain requirements of a World Bank Financial Sector Adjustment Loan (FSAL). The resident advisors interviewed each manager within bank supervision to identify the top ten objectives for each area with a time line expectation for completion. Those items were organized into "Ten Point Plans" which were aggregated and presented as part of the overall Strategic Plan for Bank Supervision in June 1997. Throughout the remainder of 1997, the bank supervision department focused on the ten point plans. In late 1997, the Senior Policy Advisor worked with the senior NBU management team to identify three - year objectives for bank supervision. The World Bank also concurred with these objectives in light of the FSAL conditionalities. This new strategic plan was finalized in late 1997 and approved by the NBU Board of Directors in February 1998.

Throughout this project, the BearingPoint resident advisor for on-site bank supervision focused on the development, testing and implementation of a written inspections manual, consisting of fifteen chapters customized to the Ukrainian banking system, and conducted regional one-week seminars followed by a three-week training examinations. The examiners worked in on-site inspections in several commercial banks where they worked with the new manual chapters, completing the procedures, developing conclusions, writing conclusion memorandums and finalizing workpaper documents.

The off-site advisor developed an early warning system, accompanied by prudential regulations. As a result, the NBU has a menu of regulations that meet international standards, including new rules on foreign exchange risk and capital distributions.

The on-site, off-site and BRU components focused on providing extensive training throughout the project. The on-site resident advisors provided numerous classroom seminars and supplemented those seminars with on-the-job training in commercial bank examinations. Classroom seminars focused on the bank inspection manual chapters, i.e., Planning and Control, Internal Controls, Loan Portfolio Management and Management and Board Processes. Regional classroom seminars were provided to introduce International Accounting Standards in the context of the Ukrainian banking system. Training in the BRU focused on the importance of the onsite examination process and how it supports the identification and resolution of problem banks.

During the summer of 1997, a BearingPoint problem bank advisor developed an approach whereby the BRU analysts would have a written approach to analyzing and dealing with their banks. This written manual of procedures provided the framework for analysts to ascertain the problems in each bank, document those problems, analyze how the BRU should address the problems and develop plans of action to work with the banks to resolve the problems, place more stringent requirements on the bank, or ultimately, pass the bank to the bank liquidation section of NBU.

To facilitate this program, a series of problem bank examinations was agreed upon with the NBU. Starting in April 1997, four banks were identified whereby the on-site examiners would conduct an on-site inspection (using the new exam procedures) and be assisted by BRU analysts. The role of the BRU was to understand the exam process through participating in the examination, review the findings of the exam, participate in the development of the conclusions and assist in prioritizing the problems within the institution which would be placed in the supervisory agreement. BearingPoint advisors assisted with these four examinations and facilitated the participation of the BRU analysts as well as the development of the supervisory agreements. The outcomes of each of these examinations included a written report of examination (in a revised, well organized format) that clearly identified the banks' problems and commitments from management to address the problems; a supervisory action that was developed by the

BRU, discussed with bank management and signed by both NBU and bank management. This process was also set forth in a procedural context via the BRU manual.

Also in furtherance of the goal of improving the NBU's capabilities regarding problem banks, the BearingPoint advisors worked with the BRU and NBU Legal Department to revise NBU Regulation 115, which eventually evolved into a better structured legal enforcement document (Regulation 38, and later Regulation 215).

Two major developments significantly impacted bank supervision in Ukraine in 1998. The first was the Russian financial crisis, which led to the failure of many banks in that country. Ukrainian banks, however, emerged relatively unscathed. That fortunate result was due to two factors: the relatively strong liquidity positions of Ukrainian banks, due in part to the introduction of minimum liquidity requirements in 1997, and the strong statements by the NBU in support of the banking system. With the participation of BearingPoint advisors, the NBU prepared contingency plans to handle possible systemic failures during the crisis, including the willingness of the NBU to provide emergency liquidity to banks with whole loans and real estate as collateral, or to purchase these assets outright. Fortunately, these lines of credit never had to be used.

The second important development was the series of diagnostic examinations of the seven largest banks, the combined assets of which amounted to more than 50 percent of the total assets of the Ukrainian banking system. Five of these banks were holdovers from the Soviet era, but at the time of the examinations only two were still in state hands. The purpose of these examinations was to ascertain the condition of each of these institutions, leading to the subsequent development of a "large bank" unit within the NBU which would oversee the development and implementation of individual bank restructuring plans. BearingPoint advisors served as examiners-in-charge at four of these seven banks, leading teams of Ukrainian and international experts. The results of these examinations led to enforcement actions and more intensive monitoring on all of these banks, and revealed that one of the banks was a prime candidate for liquidation (the liquidation of the bank commenced in 2002.)

The IMF and World Bank also became more involved in bank supervision in 1998. The IMF supplied an advisor to the newly-created "large bank monitoring unit," and the World Bank attempted to provide the NBU with a prepackaged UBPR software.⁹

3. Banking Supervision Development Project Highlights, (December 1998 – June 2002)

1999

In 1999, having set up the large bank monitoring unit to oversee the seven largest banks, the NBU turned its attention to the "Tier 2" banks. These banks, numbering about 20, were also relatively large (for Ukraine) multi-branch organizations, the failure of any of which would have sent shock waves throughout the system. BearingPoint advisors helped the NBU launch the program with a 5-week, intensive training course for examiners, followed by on-site examinations.

BearingPoint advisors also launched a series of weekly seminars in off-site supervision, covering topics such as the analysis of capital adequacy, liquidity, interest-rate risk, foreign exchange risk, asset classification and loan-loss provisions, accounts receivable, and the valuation of debt and equity

⁹ After considerable effort was expended to customize the prepackaged software to the commercial bank chart of accounts and reporting forms that were in use in Ukraine, the NBU abandoned the project in 2000.

securities. This last topic reflected a major initiative undertaken by the NBU to require banks to evaluate their considerable holdings of securities.

In off-site supervision, the NBU launched an early-warning system to catch problems at commercial banks before they became too great. A series of more than 20 automated screens were developed, and procedures were put in place to issue warning letters or apply more severe enforcement actions toward banks that appeared on those screens.

The European Union became involved in bank supervision at the NBU in 1999, with a liquidation project that had been in the planning stages since 1996. A few small banks were liquidated with help from the EU advisors, but overall the program was judged a failure and was quickly curtailed.

Finally, the NBU went through its first assessment of compliance with the *Basel Core Principles*. Although the NBU's overall rating was mixed, indicating much more had to be accomplished, the IMF team was impressed with the achievements that had been done up to that point.

2000

In 2000, the program to examine and more closely monitor the Tier 2 institutions continued. The off-site supervision training program also continued with a series of seminars at the NBU provincial offices. After this training program, the provincial offices began applying the early-warning system to banks under their supervision.

BearingPoint advisors launched another training program to take to the NBU provincial offices, this time covering off-balance-sheet risk, which had become important in the late 1990s. Additionally, there was an invitation from the Presidential Administration for a series of discussions about the banking system and bank supervision, to which the advisors responded. During that year, the government floated a proposal to separate bank supervision from the NBU, but it died in the face of opposition from the NBU. BearingPoint advisors helped the NBU marshal arguments against that proposal.

Another EU effort to assist the NBU in bank supervision was launched, with advisors focusing on developing a "dossier" – an electronic file folder of supervisory information on each bank. Once again, the NBU was not satisfied with the performance of the EU advisors, and the program was quickly terminated. BearingPoint advisors then continued with the effort, to the greater satisfaction of the NBU, and a working dossier was quickly developed.

In anticipation of another Core Principles evaluation, the NBU, with the help of the BearingPoint advisors, began a self-assessment program that continued well into 2001. This self-assessment was extremely helpful in focusing the attention of the senior management of the Supervision Department on the areas that needed more work.

2001

After abandoning the World Bank-led efforts to customize its prepackaged UBPR software, the NBU again turned to the BearingPoint advisors. In less than six months, the UBPR went from conceptual stage to actual utilization in the writing of off-site analyses. Taking advantage of this new capability, the NBU developed and implemented a new format for the preparation of quarterly financial analyses.

Another major development was the start of the long-delayed liquidation of one of the major banks. This bank had been under quasi-conservatorship, under intensive monitoring, for more than two years.

Non-bank financial institutions (NBFIs) received increased attention in 2001, with the passage of a framework law on NBFIs. The NBU participated in the drafting of that law, although it did not give the NBU regulatory authority over other types of financial institutions such as insurance companies, mutual funds, and private pension plans.

Anti-money laundering efforts also speeded up in 2001. Unfortunately for Ukraine, it appeared on the Financial Action Task Force's list of non-cooperative countries in the fight against money laundering. This concentrated the efforts of the government, and an AML law and implementing regulations were quickly adopted. BearingPoint advisors helped write the regulations on the responsibilities of financial institutions, and AML compliance was written into the examination programs.

2002

Full implementation of the UBPR came in 2002, with another series of regional seminars to introduce examiners to the new tool for analysis. The NBU also introduced regulations requiring the measurement, monitoring, and limitation of interest-rate risk, and began to focus on other aspects of market risk such as equity and commodity risk. All the while, the program of examination and monitoring of the Tier 2 banks continued, and a new procedure for recommending, processing, implementing, and monitoring enforcement actions was introduced.

The IMF conducted another evaluation of compliance with the *Core Principles*. This time, because of careful preparation and many accomplishments since 1999, the NBU received a much higher rating.

IV. SUMMARY OF USAID GOALS AND OBJECTIVES AND PROJECT ACTIVITY

The following table shows USAID's goals and objectives for this project, as set forth in the Task Order:

A. The NBU Bank Supervision Department evolves its processes so that risk-based supervision becomes the basis for both its inspection and enforcement. The following aspects of bank supervision are modified to reflect the new emphasis on risk-based supervision.	
1.	<i>On-site Inspection: BSD staff is expert, not only in financial analysis (as is presently the case), but also in analysis of how adequate the banks' risk management systems are, in light of current and foreseeable risks that the bank faces with its current and prospective range of services. Written examination procedures place greater emphasis on the risk-management system. The "CAMELS" and "Report of Examination" – for each bank examined – reflect the NBU's evaluation and recommendations for correction of any weaknesses found in the bank's risk management system.</i>
2.	<i>Offsite Analysis: MIS reports modified, based on the risk-assessment methodology. External audit results incorporated into the supervisory strategy of banks.</i>
3.	<i>Licensing: Requirements for both renewal and new bank licenses are changed to require risk management systems that meet NBU standards.</i>
4.	<i>Organization and Staffing: Supervisory personnel are trained in risk-based management [supervision]. The organizational structure of the Bank Supervision Department will be reviewed and changed to reflect the evolution of risk-based management.</i>
5.	<i>Legal Issues: Elements of the legal framework are further elaborated which deal with different aspects of the banks' required systems of risk management. In particular new implementing regulations are developed requiring risk-management units and board-approved risk limits within banks. An amendment to the Law on Banks and Banking is developed to require the internal auditors of commercial banks to report to the Supervisory Council of their bank (rather than, as currently required, to their Board of Management.)</i>
B. The banking community understands and accepts risk-based supervision. The contractor will advise and assist the National Bank in the elaboration of regulatory standards and an action plan for implementation of risk-based supervision at the commercial banks.	
1.	<i>Compliance: NBU BSD develops a plan for compliance with the new regulations on risk-based supervision.</i>
2.	<i>Diagnostic: NBU Bank Supervision Department (BSD) reviews the main products and services of a sample of the two tiers of larger banks (about 25 banks, accounting for over three-fourths of banking system assets) and assesses the types of risks relevant for each.</i>
3.	<i>Template: NBU BSD develops a template covering the panoply of risks, and describes the key elements needed for an effective risk management system.</i>
4.	<i>Tools: NBU BS develops tools for the commercial banks in implementing "risk based" systems, such as examples of policies, audits programs, MIS software for implementation by individual banks.</i>
5.	<i>Risk-based Supervision Director and Committee: The NBU designates a small group of examiners to be responsible for risk management implementation (Risk-Based Supervision Committee) and senior Bank Supervision Department Official (Risk-Based Supervision Director), who will be the NBU's primary liaison with the banks in the implementation of the new methodology. This group is responsible for training other NBU examiners in risk management, for reviewing implementation plans and policies, and for evaluating and providing on-site assistance regarding the procedures developed by individual banks.</i>

6.	Communication: NBU's "Risk-based Supervision Committee" develops seminars and prepares training materials to be made available to the banks as guidance on implementation of risk-based systems and the new NBU regulations in this area. A policy manual should be given to the bankers by the NBU early in the process to provide this guidance and as a basis for discussion at meetings with senior bankers.
7.	Role of external and internal auditors: The NBU, through its regulations and its inspection procedures, focuses on getting the management and bank boards to more rigorously incorporate, in a systematic way, analyses and recommendations of their internal and external auditors.
C. The NBU Bank Supervision Department implements an institutionalized program for training, career advancement and certification of bank supervision officials. The NBU Bank Supervision Department, USAID advisors, and World Bank advisors and instructors will work together to develop an integrated approach to establish a consistent and sustainable program for improved training and for "certification" of bank supervision personnel.	
1.	Curriculum: The NBU BSD develops a comprehensive, classroom-training curriculum for a set of core courses that all bank supervision personnel would be expected to take during their initial years in the Department.
2.	Trainers: A group of seasoned bank supervisors become classroom trainers, as part of their regular duties.
3.	Certification: The NBU develops minimum qualifications for certification of fully qualified bank supervisors. The certification process should include: satisfactory completion of a set of core courses, normally to be taken by BSD bank supervision staff (from Kiev and regions) during their first three years in the Department; successful ratings by supervisors for the candidate's experience of having worked for certain periods of time in specified fields of responsibility of the Department (e.g. on-site exams, off-site supervision, licensing, registration); a passing score on an objective Certification Test that the BSD will administer from time to time.
D. Surveys, Assessments and Ad-hoc Assistance	
1.	Gender Survey: Complete a survey of gender composition of staff, with indications of supervisory and non-supervisory personnel.
2.	Core Principles Assessment. Assist the NBU in conducting an assessment of the NBU's operational implementation of Basel Core Principles, subject to agreement by the NBU.
3.	Examination Ratings of "M" Component: Obtain an average examination rating of the "M" component of CAMELS for Tier I and Tier 2 banks.
4.	Ad-hoc Assistance Items: Assist the NBU with particular tasks on an ad-hoc basis

This section summarizes BearingPoint's achievements, measured against each of the four primary sections outlined in the USAID Task Order.

**A. Promoting Evolution of Risk-Based Supervision Processes for the
Banking Supervision Department**

1. On-site Inspection

In early 2003, we assisted the BSD with formation of a risk-based supervision implementation committee (the “RBS Task Force”). In cooperation with the RBS Task Force, we assisted with design, development and delivery of the RAS. The NBU’s Supervisory Board formally approved the RAS as part of the On-Site Inspection Manual on March 15, 2004. Our project has collected input from commercial bankers, NBU senior management, on-site inspectors and off-site analysts on the format, content and usage of the RAS, and we have used this feedback to develop needed amendments to the RAS document and to the overall supervision process. Clearly, risk-based supervision and promotion of risk management cannot be implemented by the NBU in isolation. Our project assisted the NBU to negotiate and learn from the banking industry, while maintaining strict adherence to principles and values that are integral to an effective supervisory process.

From the early RAS drafts and discussions, we conducted technical (subject matter oriented) “train-the-trainer” sessions on risk-based supervision and usage of the RAS for twenty (20) persons from the banking supervision function, nationwide. Our project has also delivered train-the-trainer sessions focused on “softer” training and communication skills, in addition to technical expertise. Senior management of the NBU selected these twenty persons mainly according to their competency as inspectors. The technical training for the RBS instructors was held November 10 through November 21, 2003. Course materials included brief presentations on risk-based supervision, key banking risks, risk management systems, risk measurement tools, corporate governance and an extensive case study illustrating all banking risks and risk-based supervision concepts. Following this seminar, the participants assisted with delivery of the three-day risk-based supervision courses, which are detailed in a later section.¹⁰ On a parallel track with the risk-based supervision program, the World Bank’s Dutch Grant project has delivered training to the BDS on individual risk components (i.e. credit risk, market risks, operational risks) and risk control processes (internal audit, compliance, internal loan review, etc.) The overall training effort has been coordinated with the NBU’s Personnel Department and the BDS Training Unit Manager, Ms. Tatyana Khimich.

Following the train-the-trainer seminar, we assisted BDS inspectors with a pilot inspection of a commercial bank using a draft version of the RAS, incorporating the concepts of risk-based supervision. This was a highly intensive inspection process focusing on each of the bank’s major risk areas, including considerable effort with on-the-job training of inspectors. This on-the-job training, coupled with formal training on risk-based supervision and individual components of banking risk will form the basis of risk-based supervision implementation.

We presented recommendations regarding the BSD’s On-site Manual section addressing RBS, including the following:

1. to expand the Manual into a Banking Supervision Manual, specifically, by including a chapter on offsite analysis;
2. to review the Manual in order to make the terminology consistent with the RAS and policy guidelines for comprehensive risk management systems in banks; and,
3. to make sure that corporate governance principles are adequately reflected in the Manual.

¹⁰ The risk-based supervision course is too lengthy for inclusion in this report, but will be delivered to the USAID Mission in electronic format.

We continued to work on the two major regulations that set forth risk-based supervision concept, the RAS and the Risk Management Guidelines. In particular, we:

1. completed a summary of RAS use by RBS seminar participants during case study training; and
2. advised appropriate personnel from NBU's Center for Policy Research on measurement indicators for some risk categories.

As mentioned earlier, the NBU slowed its pace of RAS implementation due to organizational changes in 2005. This limited our ability to interact with appropriate counterparts, in particular on the issue of risk findings communication within bank supervision.

We also worked closely with a World Bank advisor, Mr. Robert Porter, during his visit to Ukraine in 2005. In particular, we had several meetings with Mr. Porter to discuss possible approach to make RAS even more useful and to find closer relation between RAS and CAMELS systems. The result of such activity was a mutual understanding by the NBU, Mr. Porter and our advisors that RAS has to be further amended based upon the experience of its one full year implementation. Three major issues that have to be clarified are:

1. inter-dependence of the RAS with the CAMELS rating system;
2. format of the new Report of Inspection, which must guide the communication process rather than contradict it; and
3. risk categories to be examined in bank branches.

We noted these issues to NBU senior management at the commencement of the project in 2003. Both issues require strong leadership from NBU, and the lack of such leadership can have some adverse effects on RBS sustainability in the long run.

Over the course of this project, we delivered risk-based supervision seminars in conjunction with NBU trainers to nearly 500 persons. Details of these training sessions can be found in Appendix D to this report. From the feedback generated at these training sessions, we developed recommendations for future amendments to the risk-based supervisory process and the RAS. Specifically, we developed recommendations for enhancements to the standard Report of Inspection and CAMELS rating policy based to match the findings and conclusions contained in the RAS.

Other items related to this particular project component are the following:

- We prepared a memo to Mr. Krotiyuk based upon his request describing the existing practice of offsite prudential limits (economic normatives) in the United States. We have strongly emphasized that off-site data by itself can be somewhat misleading due to the accounting risk involved, and that non-compliance with prudential norms should trigger a severe supervisory reaction, as opposed to the existing practice of setting time frames to correct non-compliance. We also provided some background information in respect to risk-based supervision in the memo.
- We participated in a limited review of external audit reports being submitted to the NBU by banks according to the law. The review was rather informal and involved checking for presence of all required components (five financial statements plus the auditor's opinion) and some quality control over notes, mainly in the area of risk disclosure. The NBU was scheduled to launch an official review of external audit reports once the deadline for submission expires (May 1). The result of such review should have been action against auditors for wrongdoing and non-

compliance, as well as amendments into appropriate accounting and disclosure policies. Due to organizational changes it was not possible for this to occur before the end of the project.

- We provided comments and advice to Mr. Drozdov, Policy and Methodology Department, on the issues related to consolidated supervision over banking groups (financial conglomerates). Mr. Drozdov is responsible for drafting methodology for consolidated supervision in banks. The major challenge is a general confusion between consolidated supervision (which covers parent, subsidiary and sister companies of banks), and supervision based upon consolidated financial statements (which only include the reporting bank and its subsidiaries, but do not cover parent and sister enterprises). There are a number of “gaps” in current Banking Law that prevent the NBU from exercising full consolidated supervision to the extent necessary in the modern financial environment. It is preferable to clearly state the NBU’s authority in the text of the law. With this purpose, we provided specific recommendations for legislative amendments to implement consolidated supervision principles, as well as examples from the legislation of other countries that practice consolidated supervision.
- In February we provided written comments to Mrs. Ivanenko concerning the notion of “bank safety and soundness.” This explanation was needed to find a creative interpretation of provision from the Banking Law to hold bank managers liable for “risky operations” and any action which threatens the interests of bank’s depositors or other creditors – i.e., “bank safety and soundness.”

Our project was in constant contact with the RBS Task Force throughout our presence at the NBU. In our discussions during each of the risk-based supervision seminars, we assisted the members of the RBS Task Force with areas of possible improvements, including our delivery of a detailed “action plan” for implementation of risk-based supervision. We have carefully emphasized that the risk-based assessment system and risk-based supervision plan is a working document, to be viewed as a living document.

2. Offsite Analysis

Based on the approved RAS document mentioned above, and the overall risk-based supervisory methodology, we recommended creation of a “bank dossier,” which would capture critical financial and non-financial information from commercial banks and the bank’s overall risk profile. This would be couple with an improved “supervisory strategy” document that would allow supervisory activities based on each individual bank’s risk profile. The supervisory strategy document already incorporates external audit results. We discussed each of these documents and their usage in each three-day risk-based supervision seminar. We provided continuous feedback on these management information systems following each seminar.

Based upon request of two counterparts, Mrs. Faber and Mrs. Karcheva, we provided written comments on the existing UBPR. The UBPR, initially proposed by our project in 2002, now needs to be amended due to major changes that have occurred in accounting policies and practice. We provided advice on creation of more accurate peer groups for analytical purposes. In particular, in addition to existing “net total assets” indicator, which divided the entire population into four peer groups, the NBU now will be using another indicator – return on equity. Jointly these indicators will help to divide population into five peer groups that will be more homogeneous and more easy to use for analysis.

3. Licensing

Our legal advisors worked closely with the NBU working groups on the Banking Law and its implementing regulations, including requirements for licensing activities and risk management. At the onset, Article 19 of the Banking Law required that members of the bank's supervisory board and management board have appropriate education and experience necessary to manage a bank. While these concepts are sound, more was needed to be consistent with risk-based supervision principles. In particular, this licensing threshold should be much higher to include a proper internal audit function and risk management capabilities. We delivered a comprehensive set of recommendations to the Banking Law regarding licensing activity in May 2003 and have continued to push this area further. The Banking Law (proposed Article 44) would have considerable more detail regarding the expectation of risk management and audit functions than in the current edition.

The proposed Article 44 of the Banking Law contains much stronger and more detailed language regarding risk management and internal controls and audit activities of banks, including the following:

- Each bank must have a comprehensive and adequate system for determination, evaluation, monitoring and control of all risks.
- Each bank must have a system of internal controls and management information systems that are appropriate for the bank's size and complexity.
- Each bank should have committees for risk management, internal audit and conduct review, which should report to the Supervisory Board.
- Each bank must submit an annual report to the NBU concerning evaluation of its own risk management and internal audit units.

We are continuing to work on these items, as well as preparing for discussions later on bank corporate governance and risk management, capital of banks, purchasing by banks of their own shares, transactions with connected parties, and consolidated supervision of "banking groups" and "financial conglomerates." The submission to Parliament of a set of draft amendments to the Banking Law was initially planned for the end fourth quarter 2004. However, due to the previously mentioned political disruptions in the latter half of 2004, this was delayed indefinitely.

4. Organization and Staffing

Following advisory recommendations from BearingPoint, the organizational structure of the BSD was altered to reflect the evolution of risk-based supervision. A new, senior-level, position within the BSD was formed for the purpose of risk-based supervision implementation. Mrs. Svitlana Faber heads this new unit, entitled "Department of Risk-Based Supervision Methodology and Planning." Mrs. Faber and the "Methodology Unit" under her direction are our project's closest and most valued counterparts. Without Mrs. Faber and Mrs. Iryna Pozharska, our project would not have the momentum for change that we now enjoy. We have highlighted earlier the changes to the BSD since our recommendations were initially implemented.

As mentioned earlier, our advisors developed a comprehensive, two-week risk-based supervision program for the BSD trainers. Over the course of our project, we assisted the BSD and the RBS Task Force with delivery of nineteen (19) risk-based supervision seminars to a total of 516 participants. The seminars were held in Kyiv, Zaporozhzhya, Cherkassy, Dnipropetrovsk, Donetsk, Kharkiv, Lvov, Crimea and Odessa.¹¹ The participants were active in discussions and have voiced their concerns, positive and

¹¹ In some regions, we delivered the seminar on more than one occasion.

negative about the RAS. The participants were mostly cautious about the amount of subjectivity in the new risk-based supervision system and their resultant ability to deal with the commercial banks, armed only with their “opinion.” We must emphasize that a three-day introductory seminar is not sufficient to allow the participants to fully grasp the details of risk-based supervision, and cannot provide a complete discussion of each individual risk area of banking operations. It is only designed to provide an overview of the risk assessment system, which can only be fully appreciated and implemented through a transition or implementation phase for risk-based supervision and risk management guidelines for banks. A related project, through World Bank’s Dutch Grant program, is implementing a training program on individual risk areas. All participants stated that more training and on-the-job experience will be necessary to fully implement this program.

As noted earlier, in the references to political turbulence in Ukraine, a significant change occurred when the Governor of the NBU took personal leave and an Acting Governor was appointed. This was a temporary setback for our project, as the Governor was an active supporter of risk-based supervision and consolidated supervision principles, while the Acting Governor needed reassurance that these measures were right for Ukraine. BearingPoint advisors delivered a half-day, risk-based supervision case study to the NBU’s senior management (Acting Governor Yatseniuk and several Deputy Governors, including Mr. Shlapak, who is responsible for banking supervision) and BSD senior management (all Directors). This case study highlighted many issues relating to a bank’s deteriorating condition, which are not apparent by merely studying the bank’s financial ratios. The case study described the pro-active nature of concepts of risk-based supervision, as a method of addressing the root causes of bank problems before these issues appear in the form of deteriorating financial statements. In addition, the case study highlighted short-, medium- and long-term recommendations for full and effective implementation of risk-based supervision. Certain members of the NBU’s senior management were skeptical of the subjectivity of risk-based supervision prior to this case study; however, many indicated they saw risk-based supervision in a new light after this exercise. Our team immediately followed this case study exercise with a comprehensive action plan for implementation of risk-based supervision to build on the momentum and understanding of this concept at the senior-most levels of the NBU. This action plan continues to be used as a basis for several working groups at the NBU focused on implementation of risk-based supervision.

Other formal training initiatives include the following:

- With BearingPoint advisory assistance, Mrs. Ivanenko, Deputy Director of the General Department of Banking Supervision, participated in the course development of a seminar on Best Practices of On-Site Examinations: Regional Experience and Challenges for CEE and former Soviet Union countries, organized by the Training Initiatives for Banking Supervision (TIBS) of the NBP during the week of November 17, 2003. Ms. Ivanenko made presentations on the Ukrainian bank supervision experiences and challenges. Three other persons from the BSD also attended this forum.
- With BearingPoint advisory assistance, three persons from the BSD participated in the course on Credit Risk Management: Bankers and Regulators Perspective, organized by TIBS during the week of May 29, 2004. One person from the BSD (Mr. Oleg Kostushko) made presentations on the Ukrainian bank supervision experiences and challenges, and two other persons from the BSD also attended this forum. Our advisors have secured a more active “partnership” role with TIBS, which allows Ukraine to send more than the normal two participants per seminar.
- BearingPoint advisors coordinated a one-week discussion between the NBP and the NBU covering the topics of risk-based supervision, planning processes and advancement risk management techniques with derivative products during the week of September 6, 2004 in Kiev.

We assisted the BSD with the agenda items and the persons to be involved. The NBP covered all costs of materials preparation and speakers, while the NBU covered housing costs. USAID, through BearingPoint, covered transportation and interpretation. As can be seen above, through a cooperative and cost-sharing arrangement, our advisors have forged a stronger partnership between the National Banks of Poland and Ukraine.

- In June 2004, the Basel Committee on Banking Supervision issued the “International Convergence of Capital Measurement and Capital Standards.” The Basel Committee’s capital requirements sets an international standard, which all banks and banking supervisors need to understand. We assisted the BSD with a basic understanding of this document and developed detailed recommendations for its implementation in Ukraine.
- In May 2005, our advisors participated in a “Basel Committee Group of Banking Supervisors from Central and Eastern Europe” conference. Our advisors delivered presentations on Basel II implementation for transition economies and international accounting standards. Additionally, we assisted BSD personnel in preparing their presentations to the seminar participants.

5. Legal Issues

The legal reform component of this project has focused on three areas: beneficial owners /essential participants of banks; bank corporate governance; and consolidated supervision of banking groups. The NBU had planned to introduce amendments to the Banking Law in each of these topics in separate “tranches.” The material on beneficial owners was submitted to the Verkhovna Rada in mid-2004, but was withdrawn for further work when substantial opposition arose over the penalty provisions. The material on bank corporate governance was supposed to have been submitted to the Verkhovna Rada in the fall of 2004, but this submission was postponed due to the Orange Revolution. These amendments, and the amendments on consolidated supervision, are still being prepared.

Originally, plans were to submit the proposed amendments to the Verkhovna Rada by the end of 2005. However, recently the advisors learned from the NBU Legal Department that the strategy has changed. Current plans are not to submit the material on beneficial owners to the Rada until sometime in 2006, following the next round of Parliamentary elections. The reasoning behind this strategy is that the current composition of the Rada is not “reform-friendly,” since the Rada members were elected prior to the Orange Revolution and many are more sympathetic to the previous regime. The NBU believes that the new Rada membership is more likely to be receptive to progressive financial sector legislation.

The advisors recognize the logic of this approach. Still, in our view, it would be more efficient to submit the proposed amendments as part of a single comprehensive package, rather than in piecemeal fashion. The NBU is considering this approach. In particular, the concepts of beneficial ownership and consolidated supervision are inextricably intertwined, and cannot be segregated in a meaningful way. It is somewhat easier to carve out the corporate governance material, but even this would be more efficiently presented as part of a package, since corporate governance of bank holding companies is an important part of the consolidated supervision concept. In addition, transparency of ownership is a key component of both consolidated supervision and corporate governance. The disadvantage of the comprehensive package approach, of course, is that if the Rada members find one aspect of the package objectionable, it could sink the entire legislative effort.

Each of these items has been the subject of extensive recommendations and explanations over the past 3 years. In formulating our recommendations, we have relied primarily on EU Directives, Basel Committee documents, and legislation from Basel Committee countries. The relevant memoranda and comparison

tables containing the recommendations, and reasons for them, are included as attachments to this report. Our project has delivered comprehensive legal recommendations regarding necessary amendments to the Banking Law and various critical regulations including, but not limited to, the following topics:

1. licensing (registration) activity;
2. essential participants and controlling persons of banks;
3. collection of information from essential participants and controlling persons;
4. enforcement;
5. corporate governance and risk management principles;
6. enhancements to external and internal audit activities;
7. consolidated supervision principles, including transparency of ownership/control of banks, especially where a bank is part of a group that includes non-bank or non-financial enterprises;
8. capital of banks, especially purchasing by banks of their own shares; and
9. legal protection for the NBU for actions taken in the course of exercising its supervisory duties.

We have assisted the NBU Legal Department in their discussions with the Ukrainian banking associations and with Parliamentary working groups. Due to the unique connections between the banking industry and members of Verkhovna Rada in Ukraine, the legal and judicial areas are among the most difficult areas of reform. As issues related to legal reform are a cross cutting theme of this project, we have included a separate Appendix to discuss our recommendations. Please see Appendix C for a complete description of legal recommendations that have been provided to the NBU.

B. Promoting Acceptance of Risk-Based Supervision and Risk Management in the Banking Industry

1. Development of Plan for Compliance With Risk-Based Supervision Regulations

In 2003, we assisted NBU senior management with development of a “Comprehensive Program for the Development of the Banking System of Ukraine for the years 2003-2005.” We have also drafted a comprehensive action plan for implementation of risk-based supervision throughout the NBU organization.¹² These documents are used as the basis of risk-based supervision implementation and development of the banking industry according to modern risk management concepts. We have assisted the NBU through research and participation in discussions with commercial bankers and with banking associations.

Our assistance with banking law amendments was targeted at ensuring the NBU has the authority to enforce changes in a bank’s operations if risks are excessive or if risk management systems are inadequate for the size and complexity of the bank’s operations. We worked closely with the NBU senior management and legal personnel on issues related to strengthening enforcement measures, ensuring that penalties for non-compliance are severe enough to warrant bank management’s attention in an appropriate manner. We assisted the BSD to develop an effective quality assurance program, to ensure banking supervision personnel are properly using the risk-based supervision concepts. Finally, our training program for risk-based supervision was designed to enforce these concepts and ensure at least basic understanding of banking risks.

¹² Please see Appendix E to this report for a copy of the action plan for risk-based supervision.

2. Diagnostic Review of Sample of Larger Banks

We developed a questionnaire for commercial banks addressing various corporate governance and risk management issues. In order to achieve the best results, without fear of reprisal, we conducted the survey on an anonymous basis. However, we do know that the majority of the top two tiers of banks have completed the survey, easily surpassing three-fourths of the banking industry's total assets. In each of the "banker roundtable" sessions we conducted in 2004/5, we discussed the aggregate results of the survey with senior management of commercial banks.

The final "banker roundtable" session, for a total of nine, was completed in July 2004. Following these sessions, we prepared a summary of the results of the survey and delivered it to NBU senior management. The total assets of all banks attending the banker's roundtable discussion was over US\$19 billion, or 83% of the total banking assets in Ukraine (using data of June 30, 2004).

Jointly with NBU Governor's Advisor, Mr. Uvarov, Mr. Kutsenko published an article in NBU's official publication, the *Herald*, about Policy Guidelines for Risk Management. This further deepened the understanding of risk management and USAID assistance within the NBU as a whole.

3. Template for Panoply of Risks and Key Elements of an Effective Risk Management System

We developed a matrix of the categories of banking risk, common methods of measuring those risks and our estimation of the level and direction of those risks in the Ukrainian banking system. We also developed a similar matrix showing the major banking products and the major risks associated with each of those products. These items have been used as handouts in our risk-based supervision seminars and will be delivered to senior management after refinement from banker roundtable discussions. Please see Appendix F to view these matrices.

Bankers have identified corporate governance weaknesses, particularly at the most senior levels of bank management and the supervisory board, as one of the most serious deficiencies in the Ukrainian banking system. This is in addition to general lack of information, "know-how" or access to training in the area of risk management. In order to improve this aspect of the banking system, our advisors illustrated the matrices described above in more detail, focusing on the common methods of measurement of banking risks. We developed guidance for use by inspectors, discussing key management information systems and reports to be prepared for senior management. We prepared and submitted to NBU eight sections of a new policy document "Common Banking Products and their Associated Risks" (contained in Appendix F). These documents will to serve as an on overview of risks organized by bank products, and should serve as a guide for inspectors and bankers alike.

4. Tools for Implementing Risk-Based Systems

The "Policy Guidelines to Risk Management Systems in Commercial Banks" contains a myriad of examples of policies and audit considerations for bank management to follow in developing a comprehensive risk management system, applicable to any particular bank. This NBU document can be found in our supporting documentation and on the NBU web site. These recommendations continue to be discussed with commercial banks and the bankers association and have been approved by the NBU Supervisory Board.

5. Risk-Based Supervision Director and Committee

A risk-based supervision task force was formed in 2002, consisting of the following NBU positions: “Head of Strategy, Planning and Coordination Division,” “Deputy Head of Inspection and Monitoring Department,” “Head of Banking Legislation Improvement Unit,” “Director of Registration and Licensing Department,” “Head of Methodology Division,” “Head of Economic Analysis,” “Head of Enforcement Action,” “Head of Inspections Division,” “Head of Monitoring Division,” and “Head of Large Bank Monitoring Division.” This task force has been instrumental in the development and review of training materials and for implementation of risk-based supervision, in general. The BSD has created a methodology unit for risk-based supervision. This group is responsible for risk-based policy implementation issues. Our advisors have assisted this group in its formation and in establishing the unit’s basic responsibilities and duties. We have proposed that the unit be divided by banking risks, with the head of the unit taking charge of supervision processes. The members of this methodology unit are actively involved in training initiatives and will be involved more activity in assisting the on-site inspectors to develop cross-cutting knowledge and skill sets.

6. Communication Between NBU and Commercial Banks

With assistance from our advisors, the NBU’s Risk-Based Supervision Task Force has developed a comprehensive document titled “Methodological Recommendations on the Organization and Functioning of Risk Management Systems in the Banks of Ukraine.” This NBU document can be found in our supporting documentation and on the NBU web site. This policy manual has been developed with considerable input from the commercial banks and the bankers’ associations of Ukraine. All banks are keenly aware of its concept and have begun implementation of these recommendations. Discussion of this document is an integral part of our banker roundtable meetings. This drafting process has opened a new era of transparency for the NBU in its relations with commercial banks. The openness and transparency of this project has benefited both sides.

7. Role of External and Internal Auditors

The NBU is committed to improve the quality of external and internal audits in commercial banks, as can be evidenced by the proposed amendments to the Banking Law. As briefly mentioned earlier, external audit issues were the part of the set of submitted draft amendments to the Banking Law. The law will require external auditors to bring to the attention of the NBU any matter that they discover in the course of their audit, which could have a significant adverse impact on the bank. The auditors will be relieved of any obligation of professional secrecy when they furnish information to the NBU in connection with this requirement. Also, the auditors will be required to share their work papers and other materials with NBU representatives, if requested. We are confident that management boards of commercial banks are incorporating analysis and recommendations of internal and external auditors.

An Audit Certification Committee Policy has been adopted and the Committee established (based upon recommendations from Mr. Charles Canfield, World Bank Dutch Grant Advisor). The Committee includes nine members: five representing the NBU, four from the Audit Chamber, and one from the non-bank financial regulator agency. BSD Director Pushkariov was named Chairman and Mrs. Faber, Director of Banking Supervision Policy Department, was named its Deputy Chairman. The Certification Committee of the NBU has established procedures for renewing expired and existing external audit certificates, as well as for granting certificates to new auditors (entry requirements). Both procedures require eligible candidates to be able to show knowledge of IAS by completion of an accounting certificate program (i.e. ACCA, CPA, or its Russian language equivalent – CIPA). In this respect, we cooperated closely with other USAID-funded project, Accounting Certification administered by

Chemonics, to the mutual benefit of both projects. Our project continues to support the certification process for improvements in the audit industry.

C. Encouraging Improved Training Processes, Career Advancement and Certification of Bank Supervision Officials at the NBU.

1. Curriculum

The BSD has developed a comprehensive, class-room training curriculum for banking supervisors, which includes a set of core courses and a set of more advanced courses.¹³ The risk-based supervision seminar is listed as a core course in this curriculum.

2. Trainers

Our advisors, in cooperation with the World Bank's Dutch Grant Program, have trained a group of seasoned supervisors to become classroom trainers. This training included twenty (20) supervisory staff, and took place in November 2003. This training included a two-week seminar, developed by our advisors, discussing all areas of banking risk and focusing on the technical aspects of risk management and risk-based supervision. The World Bank Program continued with the same group of people, delivering a one-week, "train-the-trainer" seminar on methods of classroom instruction. The persons who attended these seminars are already delivering portions of formal classroom training, although it remains questionable whether this is part of the "regular duties." We have received full support from the BSD in this respect; however, the NBU's Personnel Department has remained an immovable obstacle in the path of progress towards developing a comprehensive "internalized" training program and accreditation process. We nonetheless continued our efforts to ensure that in-house training, in terms of development, delivery and participation, are made part of a person's core functions as a supervisor, not as an "extra item" when time permits. Enhancements to the training and development process are an integral part of our action plan for implementation of risk-based supervision, referenced earlier in this report.

3. Certification

This area of our scope of work has been the most problematic for a variety of reasons. The foremost area of difficulty is that training is mostly viewed as an item to be outsourced, not developed or delivered internally, and is viewed as an "extra item" to be "fitted in" only if a person has time to spare. Unfortunately, this attitude towards training leads to the unintended consequence of a general lack of training for on-site inspectors, who are the group needing the most training. The on-site inspectors rarely have "free time," thus they are not permitted to attend training and are certainly not given time to develop training materials for others. This is common for most central banks from the former Soviet Union, and stems from the historical role of banking supervision. Training is not a high priority in a compliance-based supervisory structure, as decisions made by supervisors are objective in nature. By contrast, training and communication are the lifeblood of a risk-based supervisory structure, as decisions are more subjective, requiring critical analysis of facts and the application of judgment.

The training coordinator for banking supervision is in general agreement with the concept of accreditation; however, the NBU Personnel Department would like to form an overall career development plan for the entire NBU, rather than for each department. This is a relatively positive development for NBU staff members; however, it also caused long delays, and in some instances roadblocks, in our

¹³ The training program is embodied in "Resolution #153 On the Approval of the Concept of a Comprehensive Training Program for Bank Supervision Employees," dated April 25, 2002.

implementation schedule as we did not have the resources budgeted for comprehensive assistance to the NBU as a whole.

Despite the hurdles mentioned above, we have made progress in this area. Accreditation is specifically mentioned in the comprehensive program for the development of the banking system of Ukraine for 2003-2005 and was included in our action plan for implementation of risk-based supervision, which was accepted by NBU senior management. As part of our risk-based supervision implementation, we have constantly stressed the need for a more comprehensive and formal training plan for all banking supervision personnel. Mrs. Faber, Director of Methodology and Planning, was always willing to push the accreditation program and to coordinate it with the NBU Personnel Department and she elicited our support in terms of development of a specific action plan for the accreditation implementation. Mrs. Faber has also indicated that the NBU may have some flexibility in terms of compensation schemes in this area. We developed sample test questions for validation of bank supervisors' knowledge, along with recommendations for administration of these tests as part of the accreditation program, and delivered them to the Governor's advisory group for further action. Finally, we organized meetings with the training and development officer from the Banking Supervision Department of the NBP and Mrs. Khimich.

D. Other Activities: Surveys, Assessments and Ad-hoc Assistance

1. Survey of Gender Composition

We completed the first of two surveys of the gender composition of staff in August 2002. The second survey is attached to this report as Appendix G.

2. Core Principles Assessment

We completed this assessment in May and June of 2005. The assessment results are attached to this report as Appendix A.

3. Examination Rating of "M" component of CAMELS for Tier 1 and 2 Banks.

We completed the first of two surveys of the "M" components in CAMELS in June 2003. The second survey, summarizing progress and completions through June 30, 2004, is attached to this report as Appendix H.

4. Ad-hoc Assistance Items

We participated in NBU conference devoted to new accounting treatments of financial instruments and effective rate of interest – the most sophisticated issues from IAS 39. The conference was led by the Dutch Grant advisor, Ms. Leslie Mathews-Sulenta and was held in February 2005 in NBU facilities. A total number of 50 participants from commercial bank were present.

We advised the NBU Legal Department about proposed legislative amendments to deal with crisis situations and prevent bank runs. We provided examples from the legislation of USA, Germany and Austria on so-called "bank moratoriums" and specific recommendations for legislative amendments to give NBU a legally enforceable possibility to use the tools that were found effective (if perhaps not completely legal) during Orange Revolution. We have provided numerous consultations to various related parties with respect to the effect of Orange Revolution over Ukrainian banking system and national currency stability. In particular, Mr. Kutsenko met with Mr. John Paul Shutte, First Secretary,

Economic Section, US Embassy to Kiev, and top officials of USAID OEG per request of Mr. Victor Stetsenko.

We have assisted to the NBU with the preparation of draft amendments to the Banks and Banking Law allowing foreign banks to establish branches in Ukraine. Currently, they are only allowed to operate in Ukraine through subsidiaries. We believe that allowing foreign branches is an important part of Ukraine's efforts to gain WTO accession. The proposed amendments to the Banking Law were submitted to the Parliament on April 1, 2005.

We facilitated a training seminar sponsored by USAID and delivered by representatives of the US Federal Deposit Insurance Corporation (FDIC) in May 2005. The FDIC representatives presented the formation and organizational structure of the deposit insurance function in the United States, its corporate governance, the methods of providing deposit insurance and the overall bank liquidation process in the United States.

V. PROJECT ACTIVITY WITH USAID, USAID PARTNERS AND OTHER DONOR ORGANIZATIONS

We have actively sought opinions of other USAID partners and other donor organizations, as applicable. In particular, we have worked closely with the resident representatives of the United States Treasury and the IMF on a variety of banking supervision and anti-money laundering topics. We have had good working relationships with representatives of the World Bank, and its Dutch Grant participants, in delivery of training in banking risks. We have cooperated with the representatives from the International Finance Corporation, particularly in the area of corporate governance. Finally, we have cooperated with the EU offices and their technical assistance programs, particularly the program involving risk management of commercial banks and implementation of Basel II.

VI. OBSTACLES TO SUCCESSFUL COMPLETION OF TARGETS

We have encountered two obstacles which have significantly impeded our progress. First, as has been explained in this report, the political uncertainties over the period from June 2004 to June 2005 caused a virtual stand-still in legal reforms and brought about a large-scale organization change to the NBU. Second, the NBU Personnel Department proved to be a significant obstacle to human resource improvements such as development of accreditation processes and internal training development.

VII. LESSONS LEARNED

We are pleased with the success of this project against the expected results of USAID's Mission in Ukraine. The following discusses several of the critical "lessons learned" through this assistance to the NBU and its various departments. These comments are intended to be constructive in nature and not a criticism of any shortcoming.

A. "Bottom-Up" Reforms Complement a "Top-Down" Approach

We have succeeded in changing the attitudes and mindsets of NBU senior management and other head office staff in the area of risk-based supervision. Additionally, we have enhanced the acceptance and understanding of risk-based supervision amongst all BSD employees. However, this project did not contain a significant element related to "on-the-job" training for on-site inspectors. As we learned from previous task orders in the introduction of CAMELS ratings, a presence at the "line" level for introduction of risk-based supervision would have been more effective in changing the culture of the

supervisory process and would have complemented our senior management policy changes and our training courses.

B. Interaction and Cooperation with USAID Partners

We recommend increased interaction with other USAID technical assistance providers, particularly those in the financial sector. Although not frequent, the joint meetings with other USAID advisors were beneficial to all attending. While weekly meetings might be too frequent, we consider monthly meetings to be very useful and informative. These meetings allow interaction between projects to build critical synergies and avoid duplication of effort. We would encourage consideration of this concept.

C. Human Resource Management

The NBU's Personnel Department, like many governmental entities in transitional economies, lacks many critical elements of modern-day human resource management. For instance, employees at the NBU do not have a clear career path for advancement; a merit-based system is not commonly used for promotions; training is primarily considered an external function; and internal communication channels are mostly informal and often inconsistent. The lack of modern human resource management techniques and the Personnel Department's traditional thinking hampered our technical assistance, particularly with training of trainers and with accreditation.

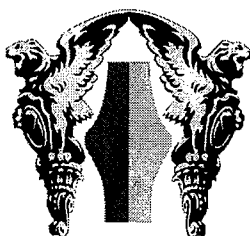
To realize the effectiveness of these areas mentioned above, USAID should consider human resource management as a critical element of future technical assistance to government entities. This element would include an analysis of existing processes and systems with an eye toward removing obstacles for advancement to modern-day human resource management. The technical advisor would issue initial recommendations for advancing human resource management systems and assist the client with this implementation. Examples of potential deliverable products are: a recruiting method for new employees, a formal and reasonably transparent career path, merit-based performance management system, an interactive training needs analysis system, and a training policy and program covering both internal and external training needs. Additionally, a highly useful tool would be an automated human resource planning system or staffing model that not only plans on-site examinations, but also includes allocations for training, annual leave, special projects, and administration. Each of these items would be based on the employee's position in the client agency and demonstrated expertise and experience.

D. Judicial Training and Technical Assistance

USAID advisors have provided considerable legal assistance to the NBU, and other areas of the financial sector, with regard to legislative changes. Technical assistance would be useful in the Ukrainian court system to educate and train judges on modern administrative law concepts, financial sector issues in general and banking issues in particular, in the context of a market economy. It is widely acknowledged that the necessary reforms in the Ukrainian legal system go well beyond training. However, judicial training on banking industry and banking supervisory issues is a necessary part of legal process reform. This type of technical assistance would emphasize the purpose and mission of a banking regulator and the method and logic of enforcement decisions. While USAID technical assistance has given the NBU the ability to recognize problems and determine their probable cause, the legal staff and the courts are hesitant to properly enforce correction of potentially unsafe and unsound banking practices, often preferring to wait for significant operating losses in banking operations before action is taken. This is quite often too late to correct the problematic situation. USAID assistance with the legal process would be beneficial to ensure the next step relative to enforcement of safe and sound operating practices. Please refer to Appendix C for more detailed information and recommendations.

VIII. CONCLUSION

BearingPoint is honored to have had the privilege of being associated with USAID's efforts to assist the NBU over the past decade. We believe that each of the success stories set forth in this report is evidence of the positive impact of USAID assistance to the NBU and the banking sector in Ukraine. Again, we would like to stress that these accomplishments would not have been possible without the cooperation and dedication of our primary counterparts at the NBU and our partners at USAID.



**UKRAINE – NATIONAL BANK OF UKRAINE
BANKING SUPERVISION DEVELOPMENT PROJECT**

FINAL REPORT

APPENDIX A

**BASEL COMMITTEE
CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

ASSESSMENT

JUNE 2005

**Prepared by Karen J. Wilson
Senior Banking Advisor**

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1. Introduction

BearingPoint advisors, in cooperation with the Bank Supervision Department (“BSD”) of the National Bank of Ukraine (“NBU”) conducted an assessment of compliance with the *Basel Core Principles for Effective Banking Supervision* (“Core Principles”), as of June 2005. We reviewed the Law on the National Bank of Ukraine (“LNBU”), the Law on Banks and Banking Activity (“Banking Law”), various bank supervision regulations and instructions. The NBU performed an initial assessment based on discussions with the department heads of the BSD and other relevant departments of the NBU. BearingPoint’s local advisor participated in many of these sessions. We not only assessed the legal framework, but also how these legal principles are used in practice. A senior consultant reviewed the initial assessment and discussed all exceptions and issues that needed clarification the head of the Methodology Department and Deputy Head of the Off-site and On-site Supervision Department. Based on those discussions this final product was developed.

This assessment is organized as follows: Executive Summary, Summary Ratings Compared to 2002 World Bank Assessment, Assessment Findings and Recommendations.

2. About the Basel Committee on Banking Supervision

Central bank Governors of the Group of Ten countries established the Basel Committee on Banking Supervision (“Basel Committee”) at the end of 1974. The Basel Committee meets regularly four times a year, and has about twenty-five technical working groups and task forces that also meet regularly. The Basel Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business, where this is not the central bank. The present Chairman of the Committee is Mr. Jaime Caruana, Governor of the Bank of Spain, who succeeded Mr. William J McDonough on May 1 2003.

The Basel Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Basel Committee encourages convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

The Basel Committee reports to the central bank Governors of the Group of Ten countries and seeks the Governors' endorsement for its major initiatives. In addition, however, since the Basel Committee contains representatives from institutions, which are not central banks, the decisions it takes carry the commitment of many national authorities outside the central banking fraternity. These decisions cover a very wide range of financial issues. One important objective of the Basel Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate. To achieve this, the Basel Committee has issued a long series of documents since 1975.

In 1988, the Basel Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by end-1992. Since 1988, this framework has been progressively introduced not only in member countries but also in virtually all other countries with active

international banks. In June 1999, the Basel Committee issued a proposal for a New Capital Adequacy Framework to replace the 1988 Accord (commonly called “Basel II”). The proposed capital framework consists of three pillars: minimum capital requirements, which seek to refine – not replace – the standardized rules set forth in the 1988 Accord; supervisory review of an institution's internal assessment process and capital adequacy; and effective use of disclosure to strengthen market discipline as a complement to supervisory efforts. Following extensive interaction with banks and industry groups, the revised framework was issued on June 26, 2004. This text will serve as a basis for national rule-making and approval processes to continue and for banks to complete their preparations for the new framework's implementation.

Over the past few years, the Basel Committee has moved more aggressively to promote sound supervisory standards worldwide. In close collaboration with many non-G-10 supervisory authorities, the Basel Committee in 1997 developed a set of *Core Principles*, which provides a comprehensive blueprint for an effective supervisory system. To facilitate implementation and assessment, the Basel Committee in October 1999 developed the “*Core Principles Methodology*.”

In order to enable a wider group of countries to be associated with the work being pursued in Basel, the Basel Committee has always encouraged contacts and cooperation between its members and other banking supervisory authorities. It circulates to supervisors throughout the world published and unpublished papers. In many cases, supervisory authorities in non-G-10 countries have seen fit publicly to associate themselves with the Basel Committee's initiatives. Contacts have been further strengthened by an International Conference of Banking Supervisors (“ICBS”), which takes place every two years.

3. Executive Summary

The NBU has implemented basic supervisory systems and is in the process of implementing more advanced supervisory processes that would move them closer toward full compliance with international standards. As this assessment of compliance with the *Core Principles* shows, there are a number of areas where process implementation is not yet complete, or where laws and regulations need modification. In addition, there are several areas that are not sufficiently covered by supervisory practices. A summary of the ratings is as follows: two (2) principles Fully Compliant (8%), fifteen (15) principles Largely Compliant (60%), eight (8) principles Materially Non-Compliant (32%), and zero (0) principles Non-Compliant. A 2004 summary of the assessments of 78 countries reviewed by the IMF/WB shows the following average levels of compliance: Fully Compliant 35%, Largely Compliant 33%, Materially Non-Compliant 24% and Non-Compliant 8%. Ukraine is roughly consistent with the global average.

A comparison of the results of the various assessments of the NBU that have been done since 1999 is difficult as the people doing the assessment, their knowledge of the principles, knowledge of the situation in Ukraine and the emphasis given to practice versus legal structure have varied. The initial assessment done by the IMF in 1999 focused on legal infrastructure and was limited in assessing actual practices. The NBU bank supervision staff's knowledge of the principles and their intent has greatly increased over time and their input to the assessment has been better informed and more critical. Finally, as experience is gained with new laws, regulations and processes or as the banking system itself changes, new issues or problems have surfaced. The benefit of a periodic assessment is partially in judging progress, but more importantly it provides a consistent set of standards for the NBU to plan for further improvements to Bank Supervision.

In 2001, the NBU, in conjunction with BearingPoint advisors, conducted an updated assessment. At that time there were five major areas that needed to be addressed. These were government interference, forbearance on reserve for loan and lease loss requirements and capital requirements, corporate

governance, required risk management systems in banks and consolidated supervision. Significant improvements have been made in all of these areas except consolidated supervision. The level of government interference is greatly reduced, although still an issue. Forbearance is not being used, although the capital issue with respect to the savings bank is still a problem. We have noticed improvements legislation regarding corporate governance. However, amendments to laws, which have been developed, need to be passed by the Rada. The NBU has put in place recommendations for bank risk management systems. These recommendations will be required by regulation in the next year based on the implementation plan. The NBU has put in place an assessment process to judge the quality of risk management systems and quantity of risk in banks and has improved its follow up on these issues. Significant amounts of classroom training in the various risk components and the risk assessment process has been done nationwide, however, continued training is needed, particularly with the individual risk components and on-the-job training for application of the risk assessment system. Finally, on consolidated supervision the NBU has implemented consolidated reporting for a banking organization and its subsidiaries. However, due to flaws in the Banking Law in defining banking organizations and the lack of transparency of ownership, the effect of this has been limited. The NBU drafted amendments to the ownership statute and legislation to effectively implement consolidated supervision. However, the Rada has not acted on the amendments relating to ownership and the amendments dealing with consolidated supervision have not yet been submitted.

In the 2005 assessment, there were three issues that greatly impacted several rating categories. These were the transparency of ownership, corporate governance and consolidated supervision. All three areas require changes to the Banking Law and amendments have been drafted for all three areas. There are also several other areas where based on experience, amendments to the Banking Law or regulations are required. One of the most important areas is capital. The NBU needs the clear authority to set capital requirements for all banks above the legal minimum and to set individual capital requirements above the minimum for individual banks that are considered higher risk. One solution is to remove the stated minimum ratio from the law and give NBU the authority to set capital requirements in regulations. Alternatively, the Banking Law needs to be amended to clarify that 8% is a minimum and the NBU has the authority to require additional capital based on the risk profile of the banking industry and/or individual banks. The NBU needs this authority to properly implement risk based supervision and the capital standards in the Basel II Accord.

Other necessary revisions to the Banking Law that are needed include authority to share all bank supervision information including inspection results with the Ministry of Finance (for Anti-Money Laundering purposes) and foreign bank supervisors for both home and host country banks. In the area of insider lending the NBU needs to be given the authority to require detailed reporting of all insider transactions. In addition, the law needs to be amended to preclude favorable rates on insider transactions. The Banking Law and the Regulation on Investments need to be changed to clarify misinterpretation of the law, which was intended to require NBU approval of significant or non-bank investments by banks. Finally, the restriction on inspection of new banks for the first 12 months of operation in the Banking Law needs to be eliminated. The NBU should have full authority to inspect any bank whenever it deems it is necessary. In particular, new banks tend to carry more risk and should be examined during their first six months of operation.

BSD staffing and training continue to be areas that require management's attention. It was noted during the review that banks are not being inspected as frequently as required by policy. Although overall bank supervision staffing levels that have been approved appear to be reasonable, bank supervision has not been fully staffed for a significant period of time. In addition, turnover continues to be high despite improvement in salaries and travel reimbursement. A review of staffing obstacles should be conducted and a plan developed to reach and maintain full staffing levels. The plan should ensure that resources are

assigned based on risk in accordance with national priorities. Efforts should be made to eliminate duplication and streamline processes wherever possible. Little reliance is currently placed on the work of internal and external audit due to weaknesses in these systems. A program to strengthen both of these areas should be undertaken with the goal of placing more reliance on these systems once they are considered satisfactory. In the long term relying on the work of others (where competent) will take some pressure off of the bank supervision resources.

As mentioned above, training has been given priority over the last 18 months. The bank supervision staff has been introduced to a Risk Assessment System and the concepts of Risk Based Supervision. Training needs to continue to be a priority to increase the level of knowledge of the various risk components and bank risk management systems. Training in these areas, particularly as it relates to credit risk management systems, is also critical to future implementation the Basel II capital calculation framework. Knowledge and procedures for the assessment of market risk and operation risk also require further development and are areas that should be given priority in training. High turnover increases the training needs to develop the knowledge and skills necessary for a qualified supervision staff. The cooperation and coordination between Bank Supervision and Personnel Departments has also greatly improved. Continued efforts to further expand the formal training program are needed.

Finally, although the *Core Principles* Assessment does not focus on implementation of the Basel II Capital Standards, the NBU as they develop a plan to further implement the *Core Principles* should take the requirements of Basel II into consideration. Achieving compliance with the Core Principles is very supportive of developing the systems necessary to implement Basel II. As mentioned above changes are required in the capital laws and regulations that allow the NBU to take into consideration market, operational and other risks in developing capital requirements for banks are necessary. In addition, inspection procedures and enforcement actions in these areas need to be strengthened. Increased disclosure and strengthening of the external audit process are also critical areas to be worked on to properly set the stage for implementation of Basel II.

The following section of the report provides more detail on the above items and additional actions needed to fully implement the *Core Principles*.

4. Summary Ratings Compared To 2002 World Bank Assessment

SUMMARY RATINGS	June 2002	June 2005
Core Principles	Assessment	Assessment
Principle 1: Effective system of bank supervision		LC
<i>1(1): Clear responsibilities and objectives</i>	FC	LC
<i>1(2): Operational independence and adequate resources</i>	FC	LC
<i>1(3): Suitable legal framework – for banks</i>	FC	LC
<i>1(4): Suitable legal framework – compliance</i>	FC	LC
<i>1(5): Suitable Legal framework – protection for supervisors</i>	MNC	LC
<i>1(6): Sharing and confidentiality</i>	FC	LC
Principle 2: Permissible activities.	FC	FC
Principle 3: Licensing Authority	LC	LC
Principle 4: Ownership	MNC	MNC
Principle 5: Investment criteria	NC	MNC
Principle 6: Capital adequacy	LC	LC
Principle 7: Credit policies	MNC	LC
Principle 8: Loan evaluation	LC	LC
Principle 9: Large exposures	MNC	MNC
Principle 10: Connected lending	MNC	LC
Principle 11: Country risk	NC	MNC
Principle 12: Market Risks	MNC	MNC
Principle 13: Other risks	LC	MNC
Principle 14: Internal controls	LC	LC
Principle 15: Money laundering	MNC	LC
Principle 16: On-site and Off-site supervision	LC	LC
Principle 17: Bank Management	MNC	FC
Principle 18: Off-site supervision	LC	LC
Principle 19: Validation of information	LC	LC
Principle 20: Consolidated supervision	MNC	MNC
Principle 21: Accounting	LC	LC
Principle 22: Remedial measures	FC	LC
Principle 23: Global consolidations	FC	LC
Principle 24: Host country supervision	FC	LC
Principle 25: Supervision of foreign establishments	LC	MNC

5. Assessment Findings and Recommendations

We assessed each of the following principles on the legal and regulatory framework and the effectiveness of supervisory practices. Each area has been assigned one of four ratings: Fully Compliant, Largely Compliant, Materially Non-Compliant, and Non-Compliant. Please see the definitions of each of these ratings below. After each summary of the specific *Core Principle*, we have provided recommendations to improve compliance, if full compliance has not already been achieved.

Ratings	Ratings Definition
<i>FC – Fully Compliant</i>	<i>All essential criteria must be met without any significant deficiencies.</i>
<i>LC – Largely Compliant</i>	<i>Only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that Principle.</i>
<i>MNC – Materially Non-Compliant</i>	<i>Shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance, but substantive progress had been made.</i>
<i>NC – Non-Compliant</i>	<i>No substantive progress towards compliance.</i>
<i>NA – Not applicable</i>	<i>Not applicable</i>

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.	LC	LC/LC	LC
Principle 1 (1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.	LC	FC/FC	LC
Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
<u>Essential Criteria</u>			
1. Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.	FC	FC/FC	FC
2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.	FC	FC/FC	FC
3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.	FC	FC/FC	LC
4. The supervisor participates in deciding when and how to affect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).	LC	FC/LC	LC
5. Banking Laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.	FC	FC	FC
<u>Additional Criteria</u>			
1. The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.	FC	FC/FC	FC
2. The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.	LC	LC/LC	LC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS – PRINCIPLE #1(1)

The legal framework as established in the Law on the National Bank of Ukraine (NBU) and the Banking Law is basically sound. The NBU establishes the right of the NBU to establish prudential regulations. Based on experience the NBU has had with the current Banking Law, and the regulations written to implement the Banking Law, we noted areas needing further improvement. Major improvements are needed in the areas of transparency of ownership, corporate governance and consolidated supervision. Amendments to the Banking Law have been drafted, and the NBU plans to submit them to the Rada in priority order. The NBU issued guidance on minimum requirements for bank risk management systems in 2004. The “guidelines” will be converted to a “regulation” next year. The NBU chose this incremental approach to provide banks the time to develop needed processes and to better understand the minimum expectations of the NBU before enforcement of these expectations commenced. The NBU needs to devote increased attention to the issue of public disclosure for banking organizations. Major improvements have been made in the area of disclosures since the previous Core Principles assessment, but further work needs to be completed to meet the requirements of the Basel II’s “third pillar.” The BSD has already begun developing plans for these requirements.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 1 (2): Each such agency should possess operational independence and adequate resources.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.	LC	FC/FC	MNC
2. The supervisory agency and its staff have credibility based on their professionalism and integrity.	LC	FC/FC	LC
3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:	LC	LC/LC	LC
> salary scales that allow it to attract and retain qualified staff;	MNC		MNC
> the ability to hire outside experts to deal with special situations;	MNC		MNC
> a training budget and program that provides regular training opportunities for staff;	FC		FC
> a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and	FC		FC
> a travel budget that allows appropriate on-site work.	MNC		MNC
<u>Additional Criteria</u>			
1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law.	LC	LC	LC
2. Where the head of an agency is removed from office, the reasons must be publicly disclosed.	FC	FC	FC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS – PRINCIPLE #1(2)

Although the government's influence and interference in the banking supervision process and with the banking industry in general are greatly reduced from previous years, this continues to be a factor. Interaction with the government and efforts to influence NBU continues to occur with the two, large state-owned banks. The ultimate resolution of this situation will not occur until the government no longer has an ownership interest in these institutions. In addition, public officials at various levels frequently have an interest in a banking organization and try to unduly influence the NBU. The most effective way of

dealing with these efforts is to have a process that would document such interactions with government officials and make such information publicly available.

The NBU has adequate resources available to it to fund bank supervision efforts. However, the Banking Supervision Department has a significant staffing problem. Turnover is high, which is in part due to salaries that are not competitive with the banking industry, particularly in Kiev. Salaries are restricted as the LNBu makes NBU employees subject to civil service laws. Although the NBU has taken various steps to improve compensation, this remains an issue. The Banking Supervision Department is currently not able to adequately fill vacancies and stem high turnover. They have been operating at lower staff levels and have not met established inspection schedules. NBU management needs to take steps to identify and correct these issues and ensure that the bank supervision function is adequately staffed and critical employees retained. The following issues are amongst the most serious relating to recruiting and staff retention:

- The high amount of travel involved in the job of bank supervisor in many locations is frequently a significant cause of turnover. This is exacerbated when reimbursement for realistic travel expenses is not provided. This is an area that should be considered in reviewing the overall staffing issue.
- Although the Banking Law authorizes the NBU to hire outside experts, this is not generally done or properly included in periodic budgets. Especially in view of the staffing issues, the NBU should consider whether there is a role for outside experts in bank supervision. If so, a process needs to be developed to budget and hire such people.
- The training budget and, more importantly, the training process in addition to relationships between bank supervision and personnel departments have greatly improved. During 2004 and to date in 2005, the NBU has made a significant commitment to providing training. This has been critical to the initial implementation of risk-based supervision. The NBU needs to continue heavy support to the training function to provide more in-depth knowledge of the risk components and bank risk management systems. This will also be needed in the future to implement the Basel II Capital Standards. The lack of consistency in the skills of the various Regions, and the need to train new employees in view of high turnover, require a continued high level of commitment to the training function in terms of money and time. The NBU should continue the implementation of a formal training and development program, which will provide for orderly, cost effective development of bank supervision staff. The Deputy Governor in charge of Bank Supervision has indicated that training is one of his top priorities.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 1 (3): A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The law identifies the authority (or authorities) responsible for granting and withdrawing banking licenses.	FC	FC/FC	FC
2. The law empowers the supervisor to set prudential rules administratively (without changing laws).	LC	LC/LC	LC
3. The law empowers the supervisor to require information from the banks in the form and frequency it deems necessary.	LC	LC/LC	LC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS – PRINCIPLE 1(3)

As mentioned under principle 1(1), the Banking Law is generally sound. However, there are three areas where the Banking Laws and regulations need to be strengthened. These are the transparency of ownership, corporate governance and consolidated supervision. The NBU has begun to correct these problematic issues, yet continued efforts and heightened emphasis on amendments to legal infrastructures in these areas is necessary.

An additional potential problem that has occurred is the interpretation of the minimum capital ratio requirement in law. The “minimum” capital ratio is set as a minimum, but is interpreted by many bankers as a “maximum” or acceptable level of capital regardless of the level of risk the institution accepts. The NBU needs clear authority to set capital requirements for all banks above the legal minimum and to set capital requirements above the minimum for individual banks that are considered higher risk. One solution is to remove the stated minimum ratio from the law and give NBU the authority to set capital requirements in regulations for an industry wide minimum capital ratio, based on risk of the system and minimum capital ratios of individual banks based on their risk profile. The NBU needs such authority to be able to implement the Basel II’s “second pillar” in the future.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 1 (4): A suitable legal framework for banking supervision is also necessary, including ... powers to address compliance with laws as well as safety and soundness concerns.	LC	LC/LC	LC
Essential Criteria			
1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.	FC	FC/FC	FC
2. The law permits the supervisor to apply qualitative judgment in forming this opinion.	MNC	MNC	MNC
3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.	FC	FC	FC
4. When, in a supervisor's judgment, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to: > take (and/or require a bank to take) prompt remedial action; > impose a range of sanctions (including the revocation of the banking license).	LC	FC/FC	LC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS – PRINCIPLE 1(4)

Bank supervision reports legal obstacles on taking action in situations where the supervisor reaches a qualitative judgment, rather than quantitative finding, during the supervision process. We recommend that the legal department and bank supervision management identify these areas and determine how these decisions can be better documented or what amendments to the Banking Law or regulations or other actions are needed. Additionally, banking supervision personnel report that the courts are reluctant to give deference to the qualitative judgments of bank supervisors. Admittedly, the right to exercise judgment is an earned right. Nonetheless, this is a critical issue as the key to quality supervision is the judgment of a capable, well-trained staff.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 1(5): A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.	LC	LC	LC
<u>Essential Criteria</u>			
1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.	LC	LC	LC
2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.	LC	LC	FC

WORLD BANK ASSESSMENT 2002 – MATERIALLY NON-COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS – PRINCIPLE #1(5)

We understand that there have been no instances in which NBU employees have been sued personally for actions taken in the course of their official duties. In fact, there appears to be virtually no possibility that an NBU employee could be required to pay damages out of his or her own pocket for such actions. Although the LNBU does not provide for legal protections of supervisors, Civil Code Article 1172 requires legal entities to indemnify for any damage inflicted by their employees during performance of their official functions. Also, Civil Code Article 1174 provides that damage inflicted to a physical or legal person as a result of illegal decisions, actions or inactivity of the official of the state government, shall be indemnified by the state irrespective of the guilt of this official. These sections seem to provide sufficient protection for individual NBU officials and employees.

Still, two issues are cause for concern:

- 1) potential institutional liability of the NBU itself for supervisory decisions that are determined to be invalid by a court; and
- 2) potential liability of provisional administrators and liquidators of banks (who might not be NBU officials or employees, and thus not covered by Articles 1172 or 1174 of the Civil Code).

The Civil Procedural Code and the Banking Law both contain provisions under which a person can sue the NBU for damages. There is no indication in either of these provisions that the action must have been taken in bad faith before a person is entitled to compensation for damages. In our opinion, these provisions are not in accordance with international best practices on this issue and do not provide the NBU with sufficient protection to ensure full compliance with Basel Principle 1(5).

To address these issues, we provided a new article for the Banking Law, which could be placed either in the Banking Law or the LNBU. Please refer to our June 30, 2005 memorandum on this issue for more detailed information.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 1 (6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.	LC	FC/FC	LC
Essential Criteria			
1. There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.	FC	FC/FC	LC
2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.	LC	LC/LC	LC
3. The supervisor: > may provide confidential information to another financial sector supervisor; > is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as confidential by the receiving party; > is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.	LC	LC/LC	LC
4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS – PRINCIPLE #1(6)

The Banking Law makes the appropriate provisions for sharing information with foreign regulators in Article 62. However, this is in conflict with Article 60, which prohibits sharing information from inspections. Information from inspections is the primary type of information that should be shared. In addition, providing information to the Ministry of Finance, which is responsible for Anti-Money Laundering (AML) measures, is also constrained by the Banking Law. The Banking Law needs to be amended to ensure that these conflicting provisions are resolved and allow for the sharing of information with foreign supervisors and the Ministry of Finance on AML issues.

The NBU has entered into Memorandums of Understanding (MOU) with Lithuania and Cyprus. The NBU has proposed MOUs to other countries that are home country supervisors, but have been unsuccessful in reaching agreements to date. Negotiations on a document with the Russian Federation supervisors are currently in process.

OVERALL COMPLIANCE RATING 2005 – PRINCIPLE #1 – LARGELY COMPLIANT

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.	FC	FC/FC	FC
<u>Essential Criteria</u>			
1. The term “bank” is clearly defined in law or regulations.	FC	FC/FC	FC
2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.	FC	FC/FC	FC
3. The use of the word “bank” and any derivations such as “banking” in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.	LC	FC/FC	LC
4. The taking of proper bank deposits from the public is reserved for institutions that are licensed and subject to supervision.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – FULLY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #2

The NBU is fully compliant with principle #2. No action required.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.	FC	FC/FC	FC
2. The criteria for issuing licenses are consistent with those applied in ongoing supervision.	FC	FC/FC	FC
3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.	FC	FC/FC	FC
4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.	FC	FC/FC	FC
5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.	LC	LC/LC	LC
6. A minimum initial capital amount is stipulated for all banks.	FC	FC/FC	FC
7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include: (1) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (2) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.	LC	LC/LC	LC
8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.	LC	LC/LC	LC

9. The operational structure is required to include, inter alia, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.	LC	LC/LC	LC
10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.	FC	FC/FC	FC
11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.	NA	NA	NA
12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of "no objection") of the home country supervisor is obtained.	FC	FC/FC	FC
13. If the licensing, or supervisory, authority determines that the license was knowingly based on false information, the license can be revoked.	FC	FC/FC	FC
<u>Additional Criteria</u>			
1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.	FC	FC/FC	FC
2. At least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue.	NC	NC/NC	NC
3. The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.	MNC	FC/LC	NC

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #3

Although the licensing department checks ownership and ownership suitability, the transparency of ownership is not always present. Amendments to the Banking Law are being proposed to improve the requirements for disclosure of ownership. Frequently the NBU has difficulties in tracing the true beneficial owner of a banking organization. Amendments should provide for rejection of a corporate application for lack of transparent ownership.

Although the licensing department obtains and analyzes business and strategic plans, sufficient follow up on feasibility and reasonableness of these plans after the bank is open by licensing personnel and bank

supervisors is not evident. Further, the Banking Law restricts inspections on new bank for the first year of operation. This is not acceptable and not consistent with the spirit of the Basel Core Principles. New banks generally carry a higher risk and should be more closely monitored by off-site and on-site supervision. We recommend that the Banking Law be amended to include, at a minimum, the following: an on-site examination of new banks should be conducted during the first six months of operation, and off-site supervision should monitor strategic and business plans submitted to licensing personnel to determine performance and needed follow up to significant deviations.

We also recommend that at least one member of a bank's Supervisory Council have knowledge of each business the bank intends to pursue. Additionally, at least one member of the Supervisory Council Audit Committee should have a financial background. The Banking Law and various implementing regulations should be amended to incorporate these requirements.

The licensing regulation and process does a limited check on whether proposed managers and supervisory council members are "fit and proper". The criteria for a "fit and proper" person should be more thoroughly defined and investigated.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.	MNC	LC/LC	MNC
<u>Essential Criteria</u>			
1. Law or regulation contains a clear definition of “significant” ownership.	FC	FC/FC	FC
2. There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.	MNC	LC/LC	MNC
3. The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.	LC	LC/LC	MNC
<u>Additional Criteria</u>			
1. Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – MATERIALLY NON-COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #4

Although the Banking Law appears to be sound, in practice the NBU has had difficulties in implementation relative to the transparency of ownership. The NBU generally requires documents that would provide detail on ownership through two tiers. This is frequently insufficient to determine the true beneficial owner or indirect shareholders of the bank. Amendments to the law have been proposed and rejected by the Rada. The NBU plans to pursue changes to this portion of the law. The NBU should have the right to deny a license or change of control if adequate information to determine the true owners is not submitted and maintained. We also recommend that the Banking Law be amended to provide heavy penalties and fines if a change in control takes place without the proper notification and approval of the NBU.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.	MNC	MNC/MNC	MNC
Essential Criteria			
1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval.	MNC	LC/MNC	MNC
2. Laws or regulations provide criteria by which to judge individual proposals.	NC	LC/NC	NC
3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organizational resources to handle the acquisition/investment.	NC	MNC/NC	NC
4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – NON-COMPLIANT

COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

RECOMMENDATIONS - PRINCIPLE #5

Although Article 50 of the Banking Law appears to be adequate, in requiring approval of the NBU for any investments in excess of 5% of capital or any investment in a non-financial service business, its interpretation has made the rule ineffective. The law was intended to only exempt investments of less than 5% of capital in firms solely engaged in financial services. All other equity investments should require the approval of the NBU. Instead, the two requirements have been separated and construed as separate conditions. In addition, the NBU has interpreted the law such that if a bank has “investment authority” under Article 47 of the Banking Law, then there is no need to apply for approval.

The NBU should develop a new regulation and application process, which requires NBU approval for all equity investments over 5% of capital or any equity investment in a non-financial services company. The standards of Article 47 should be used to determine if the application should be approved. Although the translation of the law we used does not appear to need amendment, if this is not the case, the Banking Law should be amended.

The regulations do not currently provide limits on individual investments (15% of capital) and aggregate investments (60% of capital) for all investments. This is necessary for consistency with Basel II.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 6: Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.	FC	FC/FC	FC
2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks are included.	LC	LC/LC	LC
3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.	FC	FC/FC	FC
4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.	LC	FC/FC	MNC
5. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.	FC	FC/FC	FC
6. Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.	FC	FC/FC	FC
<u>Additional Criteria</u>			
1. For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basel Capital Accord.	FC	FC/FC	FC
2. The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.	FC	FC/FC	LC
3. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.	MNC	LC/LC	NC
4. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, minimum requirements may be higher than the Basel Accord.	FC	FC/FC	FC

5. Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.	LC	FC/FC	NA
6. Laws or regulations stipulate a minimum absolute amount of capital for banks.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 - LARGELY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #6

The primary area of non-compliance with this principle is the lack of a capital requirement for market risk. The NBU, however, has raised their minimum capital ratio from 8% to 10% for all banks. This is sufficient to offset the market risk currently evident in banks' profiles. The NBU needs to further develop their bank supervision processes to deal more effectively with market risk, as further discussed in principle 12, including an appropriate capital charge for an individual bank's market risk.

An additional potential problem that has occurred is the interpretation of the minimum capital ratio requirement in law. The capital ration is set as a minimum of 8% but is interpreted by some as a maximum or an acceptable level regardless of the institution's risk profile. The NBU needs the clear authority to set capital requirements for all banks above the legal minimum and to set individual capital requirements above the minimum for individual banks that are considered higher risk. One solution is to remove the stated minimum ratio from the law and give NBU the authority to set capital requirements in regulations. Alternatively, the law needs to be amended to clarify that 8% is a minimum and the NBU has the authority to require additional capital based on the risk profile of the banking industry and/or individual banks.

Although the NBU has developed a regulation that requires consolidated reporting for a bank and its subsidiaries, practices to implement this regulation have not been instituted. Monitoring the consolidated capital ratios needs to be implemented.

In the past, bank capital planning has been focused on maintaining the minimum capital requirements of the NBU. As the requirements for minimum risk management systems in banks are put in place, there should be a requirement that the banks have a capital planning process based on the bank's risk profile.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors.	FC	FC/FC	FC
2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including: > a sound and well-documented credit granting and investment process; > the maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); > ensuring adequate controls over credit risk.	FC	FC/FC	FC
3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.	MNC	MNC/MNC	MNC
4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.	LC	LC/LC	LC
5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.	FC	FC/FC	FC

<u>Additional Criteria</u>			
1. The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.	FC	FC/FC	FC
2. The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.	FC	FC/FC	FC
3. The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – MATERIALLY NON-COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #7

Article 52 of the Banking Law, allows a bank to extend credit to insiders at concessionary rates. This should be amended. Preferential rates should not be given to insiders. To offset this weakness, the NBU requires that all preferential loans be deducted from capital. While this deduction does penalize the bank, it does not stop an abusive insider practice. The weaknesses in transparency of bank ownership and definitions in consolidated supervision also impede effective supervision in this area. The NBU is developing proper amendments to the Banking Law in this area.

The NBU has issued guidelines on minimum requirements for bank risk management systems, including credit risk. These will be converted to regulations next year. The BSD does issue warning letters if these minimums are not met. Once these requirements are converted to regulations, more severe enforcement action will be used if banks are in violation.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.	FC	FC/LC	FC
Essential Criteria			
1. Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.	LC	LC/LC	LC
2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.	FC	FC/FC	FC
3. The system for classification and provisioning includes off-balance-sheet exposures.	FC	FC/FC	FC
4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.	FC	FC/FC	FC
5. The supervisor determines that banks have appropriate procedures and organizational resources for the ongoing oversight of problem credits and for collecting past due loans.	FC	FC/FC	FC
6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.	FC	FC/FC	FC
7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.	FC	FC/FC	FC
8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.	FC	LC/LC	FC
9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement	FC	FC/FC	FC
10. The valuation of collateral is required to reflect the net realizable value.	FC	FC/FC	FC

<u>Additional Criteria</u>			
1. Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g., 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.	FC	FC/FC	FC
2. The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – FULLY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #8

We have assessed this principle as fully compliant, and have no recommendations for further action at this time.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.	MNC	LC/MNC	MNC
<u>Essential Criteria</u>			
1. A “closely related group” is explicitly defined to reflect actual risk exposure. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.	LC	LC/LC	LC
2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet.	FC	FC/FC	FC
3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis, concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.	MNC	LC/MNC	LC
4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.	MNC	MNC/MNC	MNC
5. The supervisor regularly obtains information that enables concentrations within a bank’s credit portfolio, including sectoral and geographic exposures, to be reviewed.	MNC	MNC/MNC	MNC
<u>Additional Criteria</u>			
1. Banks are required to adhere to the following definitions: > 10 percent or more of a bank’s capital is defined as a large exposure; > 25 percent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers. Note: Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – MATERIALLY NON-COMPLIANT

COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

RECOMMENDATIONS - PRINCIPLE #9

The weakness of the NBU with respect to this principle is largely related to the lack of transparency in the ownership of Ukrainian companies. Without proper transparency, it is difficult to determine all the related entities in a business group borrowing from a bank. Improvement in corporate governance for all businesses, including increased transparency of the ownership structure, has been “in process” within the government for quite some time and legislation is being (has been) developed. However, no action has been taken on this issue. In the interim, banks need to be diligent in obtaining information on the ownership structures and related entities of borrowers.

In addition, due to the weaknesses in transparency of bank ownership and problems in the law relating to the definition of related business organizations, consolidated supervision is not currently possible. Amendments to the law to deal with the issues related to bank ownership and consolidated supervision are being (have been) developed.

Although the NBU regularly collects information on concentrations and monitors compliance with the large borrower normative, information on specific economic sectors or geographic concentrations is not made part of the bank supervision information system. This information is collected by the Economics Department. The BSD should access this information and use it in monitoring banks’ exposure individually and systemically to industries or geographic locations that are experiencing weak performance.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.	LC	MNC/LC	LC
<u>Essential Criteria</u>			
1. A comprehensive definition of “connected or related parties” exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgments about the existence of connections between the bank and other parties.	MNC	MNC/LC	LC
2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding loans to non-related counterparties.	LC	MNC/LC	LC
3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank’s board of directors.	FC	FC/FC	FC
4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.	FC	FC/FC	FC
5. Laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralization of such loans.	FC	FC/FC	FC
6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.	FC	FC/FC	FC
7. The supervisor obtains and reviews information on aggregate lending to connected and related parties.	MNC	MNC/MNC	MNC

<u>Additional Criteria</u>			
1. The definition of “connected or related parties” established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.	FC	FC/FC	FC
2. There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.	FC	FC/FC	FC

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COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #10

The two primary weaknesses in this area relate to the use of discretion to make judgments about the existence of connections between the bank and other parties and the weaknesses in the law related to transparency of ownership of banks and other businesses. The issue of transparency was discussed under principle 9.

Although the Banking Law, as discussed in principle 7, allows a preferential interest rate on loans to insiders this is partially offset by the regulatory requirement to deduct such loans from capital. However, the law should be amended to prohibit preferential rates to insiders.

Although the NBU collects information on connected lending, they do not collect the ID code or name of the individual or company due to restrictions placed on them by a court decision. The law needs to be amended to make it clear that the NBU has the authority to collect this information.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.	MNC	MNC/MNC	MNC
Essential Criteria			
1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate counter-measures.	MNC	MNC/MNC	MNC
2. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies.	MNC	MNC/MNC	MNC
3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices, which are all acceptable as long as they lead to reasonable, risk-related, results. These include, inter alia: > The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country. > The supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures. > The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor	LC	LC/LC	LC
4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.	LC	LC/LC	LC

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COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

RECOMMENDATIONS - PRINCIPLE #11

The primary source of country risk is in overseas correspondent bank accounts and through transfer risk. The NBU has processes to capture information on both of these areas. There is, however, no formal country risk assessment process. It is believed that major country risk is already captured in existing systems. It is reported that foreign companies doing business in Ukraine are required to set up local subsidiaries. Therefore, lending is done domestically. If a subsidiary is dependent on the support of a foreign parent, this fact is taken into consideration in classifying the risk of the loan and appropriately provisioned. Although this is technically true, information and analysis of exposure to country risk should be formalized. Procedures should be put in place to ensure that this risk is taken into account in the analysis of the loan portfolios of banks.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or capital charge on market risk exposures, if warranted	MNC	LC/MNC	MNC
<u>Essential Criteria</u>			
1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.	LC	LC/LC	LC
2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.	MNC	LC/LC	MNC
3. The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.	MNC	MNC/MNC	MNC
4. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) or adhered to.	MNC	LC/LC	MNC
5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.	MNC	NC/MNC	MNC
6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.	MNC	MNC/MNC	MNC
7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.	MNC	MNC/MNC	MNC

<u>Additional Criteria</u>			
1. Either through on-site work, or through internal or independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/products traded and that it regularly reviews and understands the implications (and limitations) of the risk management information that they receive.	LC	LC/LC	LC
2. The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress testing scenarios, and the banks' contingency plans for dealing with such conditions.	NC	-/MNC	NC
3. The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VaR.	FC	-	FC

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COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

RECOMMENDATIONS - PRINCIPLE #12

The weaknesses in the supervision of market risk are primarily due to the lack of true markets and weaknesses in supervision as it relates to commodities, equities and interest rate risk in the bank's trading book. Supervision of foreign exchange risk is largely compliant. In the foreign exchange area, information is captured and controlled appropriately, but positions cannot be accurately revalued as use of a forward purchases is limited for the hryvnia and the spot market rate often deviates from the NBU official rate.

Although exposures to market risk in areas other than foreign exchange are believed to be limited, regulations and procedures for the supervision of market risk need to be developed. The accounting department has put in place regulations to provide for reserves on securities, however, due to the lack of true markets these rules are sometimes abused. The NBU is actively considering how to deal with this issue of securities valuation.

Skills and knowledge in the area of market risk, except foreign exchange risk, are limited and need to be further developed.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.	MNC	LC/LC	MNC
Essential Criteria			
1. The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.	MNC	-/LC	MNC
2. The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g. credit and market risk). These would include: > Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies. > Interest rate risk: good management information systems and stress testing. > Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.	MNC	-/LC	MNC
3. The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.	LC	-/LC	LC
4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance- sheet liabilities, as well as existing on balance sheet liabilities.	LC	-/LC	LC
5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.	LC	FC/LC	LC

6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.	LC	FC/LC	LC
<u>Additional Criteria</u>			
1. The supervisor has the authority to require a bank to hold capital against risks in addition to credit and market risk.	NC	NC/NC	NC
2. The supervisor encourages banks to include a statement on their risk management policies and procedures in their publicly available accounts.	LC	LC/LC	LC
3. Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign currency liquidity transformation.	NC	-/NC	NC
4. The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves. Foreign currency liquidity strategy is separately stress tested and the results of such tests are a factor in determining the appropriateness of mismatches.	MNC	-/LC	NC

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

RECOMMENDATIONS - PRINCIPLE #13

The NBU has issued guidelines for bank risk management systems on liquidity, interest rate and operational risk. Supervisors check these areas during on-site inspections, but additional training is needed on these risks and inspection procedures need to be more comprehensive. Where bank systems are found to be deficient, recommendations for improvement are made, but the guidelines are not currently enforceable. It is planned to convert the guidance on bank risk management systems into a regulation with required minimums next year.

The NBU has not yet developed a methodology to require additional capital of banks based on higher levels of risks in these and other areas. Banks with higher risk profiles should be required to hold additional capital. There are questions as to whether this can be done under current legislation. If not, a change to the Banking Law is needed.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying always its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.	LC	LC/LC	LC
Essential Criteria			
1. Corporate or Banking Laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.	MNC	MNC/MNC	MNC
2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organizational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address: > Organizational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance). > Accounting procedures: reconciliation of accounts, control lists, information for management. > Checks and balances (or “four eyes principles”): segregation of duties, cross-checking, dual control of assets, double signatures. > Safeguarding assets and investments: including physical control.	LC	LC/LC	LC

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.	LC	MNC/LC	LC
4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.	FC	FC/FC	FC
5. The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practices and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function: <ul style="list-style-type: none"> > has unfettered access to all the bank's business lines and support departments; > has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations; > has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; > employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly. 	LC	LC/LC	LC
6. The supervisor has access to the reports of the audit function.	FC	FC/FC	FC

Additional Criteria			
1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.	NA	NA	NA
2. The supervisor requires the internal audit function to report to an Audit Committee.	LC	LC/LC	LC
3. In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors.	NA	NA	NA

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #14

The primary weakness in this area is the role played by the Supervisory Council in the corporate governance of the bank. Amendments to the Banking Law on corporate governance issues have been developed, but have not yet been sent to the Rada. An amendment to the Banking Law was passed which changed the reporting lines of the internal auditor from the management board to the Supervisory Council. However, banks are having trouble effectively implementing this change due to limit financial expertise at the Supervisory Council level. Additional guidance may be needed, in addition to Supervisory Council education programs. Furthermore, the Supervisory Council will probably only take their role more seriously when they are held more accountable for the bank's operations.

The NBU does not have the authority to change the composition of the Supervisory Council. Although enforcement powers include removal of management, it is doubtful that this could be done based on a lack of knowledge or skill. Although the NBU has authority to approve new senior management, it does not have such authority where the profile of the bank changes and the management does not. However, NBU could require that the necessary knowledge and skills be acquired. We recommend that this be done through the enforcement process.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.	LC	LC/LC	LC
2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.	FC	FC/FC	FC
3. The supervisor determines that banks have formal procedures to recognize potentially suspicious transactions. These might include additional authorization for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.	LC	LC/LC	LC
4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank’s policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements.	FC	FC/FC	FC
5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.	FC	FC/FC	FC
6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.	FC	FC/FC	FC
7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.	MNC	MNC/MNC	MNC

8. Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.	FC	FC/FC	FC
9. The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.	FC	FC/FC	FC
10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.	MNC	MNC/MNC	MNC
11. The supervisor determines that banks have a policy statement on ethics and professional behavior that is clearly communicated to all staff.	MNC	MNC/LC	MNC
Additional Criteria			
1. The laws and/or regulations embody international sound practices, such as compliance with the relevant forty Financial Action Task Force Recommendations issued in 1990 (revised 1996).	FC	FC/FC	FC
2. The supervisor determines that bank staff is adequately trained on money laundering detection and prevention.	FC	FC/FC	FC
3. The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.	LC	LC/-	LC
4. The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.	FC	FC/FC	FC
5. If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money laundering obligations.	FC	FC/FC	FC

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COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #15

The NBU has made significant progress in implementing Anti-Money Laundering regulations and supervision. The major area of weakness is in the area of reporting. Banks are required to report significant fraud to the NBU, as well as criminal authorities. Suspicious activities relating to money laundering are reported to the Ministry of Finance, and not the NBU. The Ministry of Finance is designated as the ultimate anti-money laundering authority. Due to Article 60 of the Banking Law, the

NBU is restrained from reporting suspicious activities found in the on-site inspections to the Ministry of Finance. In addition, the NBU is restricted from reporting suspicious activities to foreign supervisors. The Banking Law needs to be amended to ensure that there is a free flow of information between all parties.

On-site inspection procedures should provide guidance to examiners on required contents of an acceptable ethics policy and include its review.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.	LC	LC/LC	LC
<u>Essential Criteria</u>			
<p>1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focusing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to:</p> <ul style="list-style-type: none"> > provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks; > determine that information provided by banks is reliable; > obtain additional information needed to assess the condition of the bank. 	LC	LC/LC	LC
<p>2. And (2) uses off-site work as a primary tool to:</p> <ul style="list-style-type: none"> > review and analyze the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information; > monitor trends and developments for the banking sector as a whole. 	LC	LC/LC	LC
3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.	LC	FC/FC	LC
4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximize the synergy and avoid supervisory gaps.	FC	FC/FC	FC

<u>Additional Criteria</u>			
1. The supervisor has procedures in place to assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.	LC	-/LC	LC
2. The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.	FC	FC/FC	FC
3. The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment. Off-site and on-site work is prioritized based on the results of that assessment.	MNC	LC/MNC	MNC
4. The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.	FC	FC/FC	FC
5. The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.	MNC	LC/MNC	MNC

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COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #16

The scope of most off-site and on-site work is not driven by risk. On-site work focuses primarily on credit risk. Although there are aspects of prioritizing the work of off-site and on-site based on risk, we do not see evidence of an integrated policy. This needs to be developed. We recommend that a strategy for each bank be developed, incorporating the role to be played by both off-site and on-site supervision. Some work has been done on this, but this needs to be finalized.

As the quality of bank risk management systems is not generally high, there is at present less opportunity to rely on these systems after minimal testing. However, as the quality of these systems improves, NBU management needs to ensure that policies and procedures provide for changes to the scope of work. In banks with strong bank risk management systems and independent, high quality internal and external audits, the scope of the examination should be limited to testing results and focusing on higher risk areas. This helps NBU on staffing issues and results in a decreased burden to banks.

Internal audit is generally judged to be insufficiently independent and in some cases not competent. The law has been change to provide for a more independent reporting line, however, implementation is still questionable. The NBU needs to determine where the major weaknesses in internal audit exist and develop a program in conjunction with the banks to improve this area so that their work can be relied on more extensively in the future. The NBU does have a regulation on internal audits.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.	FC	FC/FC	FC
<u>Essential Criteria</u>			
1. Based on the risk profile of individual banks, the supervisor has a program of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.	FC	FC/FC	FC
2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.	FC	FC/FC	FC
3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.	FC	FC/FC	FC
4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.	FC	FC/FC	FC

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COMPLIANCE RATING 2005 – FULLY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #17

We have assessed this principle as fully compliant, and have no recommendations for further action at this time.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 18: Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The supervisor has the legal authority to require banking organizations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on and off-balance sheets assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.	LC	FC/FC	LC
2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.	LC	LC/LC	LC
3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.	LC	LC/LC	LC
4. The information that is required to be submitted includes standardized prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on and off balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.	FC	FC/FC	FC
5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risk of the bank.	MNC	LC/LC	MNC

6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.	FC	FC/FC	FC
7. In order to make meaningful comparisons between banking organizations, the supervisor collects data from all banks and all other relevant entities within a banking organization on a comparable basis and related to the same dates (stock data) and periods (flow data).	FC	FC/FC	FC
8. The supervisor collects data from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #18

The NBU has put in place consolidated reporting for banks and their subsidiaries. This is a major improvement from previous assessments. Processes to work with this data are still in process of development. The major issue in this area is the ability of the NBU to receive information from banks and related parties that it deems relevant to the assessment of risk in the bank. As mentioned previously, the NBU was restricted in receiving code IDs and names on loans to connected parties. In addition, the issues of transparency and authority to perform consolidated supervision are problems in this area. Amendments to the Banking Law are in process.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.	LC	FC/FC	LC
2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.	LC	LC/LC	LC
3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.	LC	FC/LC	NA
4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.	FC	FC/FC	FC
5. The supervisor has a program for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns, such as that for capital adequacy be examined at least annually by the auditors and a report submitted to the supervisor.	LC	FC/FC	LC

<u>Additional Criteria</u>			
1. The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.	FC	FC/FC	FC
2. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.	FC	FC/FC	FC

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COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #19

The NBU primarily relies on its on-site inspection of banks by their staff rather than on external audits. There have been concerns with the quality of external audits and therefore, only minimal reliance is placed on their findings and conclusions. A mechanism is now in place for the NBU to participate in the certification of both external auditors and firms. The NBU does not generally use external auditors to do supervisory work or to monitor bank corrective actions.

The NBU needs to continue to work with the Audit Chamber and external audit firms to improve the quality of external audits. Once the NBU is satisfied with the quality of the external audit industry, they should consider ways to use external audit to supplement their supervisory activities.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.	MNC	MNC/MNC	MNC
Essential Criteria			
1. The supervisor is aware of the overall structure of banking organizations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.	MNC	LC/MNC	NC
2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.	NC	LC/NC	NC
3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.	MNC	LC/MNC	MNC
4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organization.	MNC	LC/MNC	MNC
5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organization. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.	MNC	MNC/MNC	MNC
6. The supervisor collects consolidated financial information for each banking organization.	FC	FC/FC	LC
7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organization group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.	NC	LC/NC	NC
8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organization is not compromised.	MNC	MNC/NC	NC

Additional Criteria			
1. For those countries that allow corporate ownership of banking companies: > the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilizes the authority in practice to determine the safety and soundness of the bank; > the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank > the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.	NC	NC	NC

WORLD BANK ASSESSMENT 2002 – MATERIALLY NON-COMPLIANT

COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

RECOMMENDATIONS - PRINCIPLE #20

There are serious weaknesses in the definitions of related organizations in the Banking Law, which combined with the lack of transparency, make consolidated supervision ineffective. As discussed earlier, amendments to the Banking Law are being proposed to correct these deficiencies. In addition, the NBU should propose amendments, which would allow the inspection of affiliates where necessary. Article 72 appears to limit the ability of the NBU to inspect affiliates who do not directly control the bank.

The NBU has sufficient information on banks and their subsidiaries, but is lacking the information and processes to deal effectively with parent organizations and affiliates. Based on current definitions, we do not see ready evidence of companies qualifying as bank corporations, bank holding groups or financial holding groups. However, based on the NBU knowledge there are affiliated companies that should be subject to their jurisdiction if consolidated supervision was practiced.

Once the legal issues are resolved, the NBU needs to put in place processes to evaluate the overall condition of parent and affiliated companies of banks with the goal of understanding the financial condition of each entity and the overall consolidated group and their potential impact, positively or negatively on the bank.

The NBU has signed MOUs with functional regulators (i.e., Securities Commission); however, no agreements have been reached on how to implement information exchange.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair value of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.	FC	FC/FC	FC
2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.	FC	FC/FC	FC
3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.	FC	FC/FC	FC
4. The supervisor ensures that there are open communication lines with the external auditors.	LC	LC/LC	MNC
5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.	LC	FC/FC	LC
6. The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.	LC	FC/FC	MNC
7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.	MNC	LC/LC	MNC
8. The supervisor has the ability to treat as confidential certain types of sensitive information.	FC	FC/FC	FC

9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.	FC	FC/FC	FC
10. The supervisor has the right to revoke the appointment of a bank's auditors.	FC	FC/FC	FC
11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognized by the supervisor as having the necessary professional skills and independence to perform the work.	NA	NA	NA
Additional Criteria			
1. The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.	LC	FC/LC	LC
2. The supervisor has guidelines covering the scope and conduct of audit programs that ensure that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, and the adequacy of internal controls over financial reporting.	FC	FC/FC	FC
3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.	MNC	MNC/MNC	MNC
4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters, which, in the context of the available information, they believe is likely to be of material significant to the functions of the supervisor.	MNC	MNC/MNC	MNC

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #21

Although the NBU requires an external audit of all banks under international auditing standards, there are concerns about the quality of work done and the quality of financial statements issued by banks particularly with respect to the quality of disclosure in footnotes. Although the NBU has a requirement to communicate with external auditors before and after examinations and audits, this frequently does not occur. Inspectors often lack an understanding of the audit process and responsibilities, which leads them to question the quality of the work. This lack of understanding also impedes open communication

between auditors and supervisors. In general, audit work papers are not shared with inspectors. Actions should be taken to increase the understanding of the role of the auditor and their standards and the requirements for communication should be enforced. Additionally, the Banking Law should be amended to impose a duty upon the auditor to report any material matters on the bank's compliance with laws and regulations, as well as, items that are likely to significantly impact the supervision of the bank.

The NBU's goal is to adopt treatments that are consistent with international accounting standards. In the accounting area, there is a weakness in the valuation rules as it relates to securities valuation and loan impairment under international accounting standards. Although the policy on the allowance for loan losses is adequate from a supervisory standpoint, it does not conform to the most recent international accounting standard for loan impairment. The Banking Supervision Department, in conjunction with the Accounting Department should consider revisions to the loan and lease loss policy. The valuation of marketable assets is also problematic due to the lack of true markets. Although a reserve policy on securities was put in place, it is not consistent with the most recent versions of international accounting standards and is being abused by the banks. The Accounting Department is working on this issue.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.	LC	LC/LC	LC
<u>Essential Criteria</u>			
1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking license.	FC	FC/FC	FC
2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a take-over by or merger with a healthier institution, and imposing conservatorship.	FC	LC/LC	FC
3. The supervisor ensures that remedial actions are taken in a timely manner.	LC	LC/LC	MNC
4. The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.	MNC	MNC/MNC	MNC
<u>Additional Criteria</u>			
1. Laws and/or regulations mitigate against the supervisor unduly delaying appropriate corrective actions.	MNC	MNC/MNC	MNC
2. The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.	FC	FC/FC	FC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #22

The NBU has implemented regulations and processes to ensure appropriate enforcement actions are taken on banks. There is a wide-range of tools currently in use. This area has improved, but there still needs to be attention paid to the timeliness of actions. The weakest part of the process is the ability to issue penalties. The penalties provided for in the Banking Law are minimal and do not act as a sufficient deterrent to illegal activities or failure to correct problems. They are also limited in scope as not all managers below the level of the management board are subject to fines.

It also appears that the ability to remove individual managers and permanently bar them from banking is lacking. This is somewhat mitigated by the NBU authority to approve bank management, although this approval process is only applicable to the most senior levels of management. Actions should be taken to strengthen the NBU ability to remove managers and bar them from banking, given knowing and willful violations of Banking Law or conduct that endangers the bank and its depositors.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 23: Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.	LC	LC/LC	MNC
Essential Criteria			
1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.	MNC	LC/MNC	MNC
2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.	MNC	LC/MNC	MNC
3. The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified b) assessing in an appropriate manner compliance with internal controls c) ensuring effective local oversight of foreign operations.	LC	FC/FC	LC
4. The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.	LC	LC/LC	LC

<u>Additional Criteria</u>			
1. The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.	FC	FC/FC	FC
2. The supervisor ensures that management's local oversight of foreign operations is particularly close when the foreign activities have a higher risk profile and/or when they differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the principal locations at which the bank conducts comparable activities.	LC	FC/FC	FC
3. The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operation. The supervisor meets the local supervisors during their visits.	FC	FC/FC	FC
4. The home country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.	NC	NC/NC	NC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #23

The NBU has sufficient authority and an adequate process to supervise the overseas branches of domestic banks. At the current time, only one bank has an overseas branch, located in Cyprus. The NBU does not have the authority or process to adequately supervise overseas subsidiaries, joint ventures or affiliates. In addition, due to weaknesses in transparency of ownership and consolidated supervision, the precise level of overseas activity is unknown. Once the Banking Law is changed and the NBU has adequate information about existence of these relationships, adequate processes can be put in place.

The NBU has not done a formal evaluation of the quality of supervision in Cyprus, but has established a positive working relationship with this regulator and are pleased with the information obtained from them and the level of oversight.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.	LC	MNC/MNC	LC
Essential Criteria			
1. For significant overseas operations of its banks, the home country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.	LC	LC/LC	FC
2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.	MNC	MNC/MNC	MNC
3. The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.	LC	MNC/MNC	LC
Additional Criteria			
1. A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.	MNC	MNC/MNC	MNC
2. Even for less than significant overseas operations of its banks, the home country supervisor exchanges appropriate information with host country supervisors.	LC	LC/LC	LC

WORLD BANK ASSESSMENT 2002 – FULLY COMPLIANT

COMPLIANCE RATING 2005 – LARGELY COMPLIANT

RECOMMENDATIONS - PRINCIPLE #24

We have noted only one situation where the NBU is the home country supervisor, which is the branch in Cyprus. In this case, the home/host country supervisor relationship is handled in a satisfactory manner.

However, despite the signing of a MOU, the NBU is constrained from providing full information by the Article 60 of the Banking Law. This restriction should be eliminated.

Although the NBU has the authority to prohibit a bank from establishing a branch in a country where there is an insufficient flow of information, no such authority exists with respect to subsidiaries and affiliates.

The NBU does not have a process to take action based on the information received from another regulator. To date, no such action has been taken. It is the practice of the NBU to independently verify the information received.

Principles and assessment criteria	Compliance level	Laws/ Regulations	Practice
Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.	MNC	MNC/MNC	MNC
Essential Criteria			
1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.	FC	FC/FC	FC
2. For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practices consolidated global supervision.	MNC	MNC/MNC	MNC
3. The host supervisor, before issuing a license, determines that approval (or no objection) from the home supervisor has been received.	FC	FC/FC	FC
4. The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.	MNC	MNC/MNC	MNC
5. Home country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.	FC	FC/FC	FC
6. The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.	NA	MNC/MNC	NA
Additional Criteria			
1. The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders.	MNC	FC/NC	NA

WORLD BANK ASSESSMENT 2002 – LARGELY COMPLIANT

COMPLIANCE RATING 2005 – MATERIALLY NON-COMPLIANT

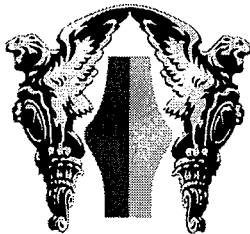
RECOMMENDATIONS - PRINCIPLE #25

The only home country supervisor that has entered into a MOU with the NBU is Lithuania. Although the NBU has sent MOUs to all of the home country supervisors for their banks, they have failed to enter into the agreements. The NBU is in the process of negotiating an agreement with the Russian Federation

supervisors; however, other regulators have not expressed an interest in establishing this relationship. Currently, the Ukrainian banks do not represent a significant portion of the overall banking organizations of these countries, which may explain their lack of interest. This, however, may soon change.

As noted previously, a problem with information sharing is evident, even if MOUs are signed, due to restrictions under Article 60 of the Banking Law. The Banking Law needs to be amended to eliminate any restrictions on the free flow of information with foreign supervisors.

The NBU does not evaluate the level of supervision of the home country supervisors and currently does not get information on the overall banking organization from the home country supervisors. The NBU should try to restart this process with those countries where their banks are more significant or in the near future are likely to be more significant to the overall banking company. The NBU may want to consider a licensing requirement that would require that a signed MOU with the home country supervisor be in place before approval of any licensing applications. This might result in the bank putting pressure on the home country supervisor to enter into these agreements.



**UKRAINE – NATIONAL BANK OF UKRAINE
BANKING SUPERVISION DEVELOPMENT PROJECT**

FINAL REPORT

APPENDIX B

**THE ORANGE REVOLUTION AND
UKRAINE’S FINANCIAL INSTABILITY**

1. The Lead Up to Financial Instability

The presidential elections began to have an effect on the banking sector, and on currency exchange rates, as early as mid-October. Due to the uncertainty of the first round outcome, delayed by the Election Commission for ten days, people began to sense problems on the horizon. A widespread rumor of country separation probably had the most drastic effect on banking system liquidity. Following the second round of elections, the former government failed to anticipate the reaction of people to a perceived fraudulent election process. We now know that the “perception” of election fraud turned out to be actual fraud on a systemic and massive scale. The opposition was very well organized and dedicated to its mission. Since the opposition announced well in advance that they would take to the streets in protest of a flawed election, it seems the former government simply underestimated the opposition’s resolve. The government appeared to believe that any protests would be short in duration. As the resolve of the opposition became better known, the government became increasingly desperate. This resulted in President Kuchma saying the opposition protests were causing the financial system to be a “house of cards” that could collapse at any moment, and this would not be his fault nor would this be the fault of the government because the protesters are blocking them from going to work. At roughly the same time, the former government apparently began to encourage rumors of country separation, again as a result of opposition protests. Rumors of a separation were relevant since the headquarters of most banks is in the west of Ukraine. In general, people in Eastern Ukraine are less educated about the function of a modern banking system and more susceptible to rumor.

The hyper-inflationary periods in the early 90s and the financial crisis and currency devaluation of 1998 were still quite fresh in people’s minds and in the minds of investors. Compounding the difficulties of the political crisis, the general lack of transparency in the financial sector allowed the press to interpret rumors. As a backdrop to this period of political instability, we witnessed a period of financial sector instability as well. Although growing rapidly, the banking sector in Ukraine is relatively fragile. Confidence is easily shaken as people are still only learning how a commercial bank functions. A country’s central bank should be viewed as a stabilizing force in a period of financial stability through its powers to counter the effects of widespread rumor and its discount window operations for commercial banks. However, in the case of Ukraine, the fact that the NBU’s Governor became campaign manager for the Prime Minister without resigning from the NBU created an appearance of a large conflict of interest and questionable independence of the central bank. This brought into question the effectiveness of the critical lender of last resort functions. Another safety net against financial sector panic is typically provided by a deposit insurance system. However, the deposit insurance system in Ukraine has a minimal coverage amount and remains mostly untested and not trusted.

2. Instability in the Banking Sector

2.1 Bank Deposits Market

From public data, it seems that people became reluctant to place deposits in banks about one month before the presidential elections were held. Total deposits had increased by nearly 40% until October 1. After this date the deposit market stopped growing, eventually turning to a net withdrawal of funds after the first round of elections on October 31st. We have seen one “trend in a trend” in these figures. Over the period of instability, as personal deposits fell, corporate deposits rose. This can be explained in part by persons taking their money from bank accounts and buying durable goods. People were buying items such as cars and household appliances with the cash from bank accounts, as durable goods were viewed as a safe haven from the financial system. Legal entities are then re-depositing these funds in their corporate accounts, mostly in foreign currency, again as a hedge against devaluation of the Hryvnia. Of course, this rush to purchase durable goods also contributed to inflation.

2.2 Inter-Bank Market

The inter-bank market continued to function throughout the crisis; however, banks were making closer judgments about their counterparts. News publications indicated that large banks and the overall payment system were functionally well but smaller banks, particularly those that are actually treasury operations for financial industrial groups, may be experiencing more liquidity problems. For the period of October 20-26, the bid rate for overnight inter-bank funds was between 3% and 5%, with a spread of 2-4% between “bid” and “ask”. On October 29, the last working day before the first round of presidential elections, the inter-bank market stiffened, causing the bid rate to jump to 30%, with an additional 30% spread to an asking price of 60%. For a sustained period of instability, the bid rate generally held between 20% and 30%, with a 10-15% spread. As of December 7, the bid rate was quoted at 25% with an asking rate of 30%. The NBU reserves fell during the crisis as they were actively selling dollars to stabilize the inter-bank market.

2.3 Capital Market

In addition to the deposit declines, market liquidity was also an issue for consideration. The bond market in Ukraine is not a liquid or deep market in normal times. Banks are the most dominant market participant in capital markets, and are mostly “buy and hold” investors, not traders. With most market participants appearing on the sell side of transactions, the market value of relatively illiquid long-term financial instruments became likely to fall. In a panic situation, the fall in values could have been quite significant.

Many of the largest commercial banks in Ukraine have received large, short- and medium-term, foreign currency syndicated loans from major Western banking institutions. Over the past few weeks, the ratings agencies have downgraded the foreign currency deposit ratings of Ukrainian banks and the deposit and bond ratings of the sovereign and the rated commercial banks are under review. Unless this period of instability is resolved in the near term, the cost of syndicated loans could rise significantly, which could negatively impact earnings performance and capital

growth. In the worst case, the leaders of the syndications could call their facilities at maturity, leaving the banks with large liquidity gaps.

2.4 Foreign Exchange Market

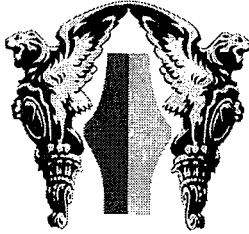
The NBU maintained a goal of exchange rate stability for several years. Until the election season began, it was widely viewed that the National Bank forced the exchange rate to be undervalued to assist Ukraine's export industries. The main export industries are concentrated in Eastern Ukraine, and are mostly ferrous metals producers and other heavy industry manufacturers. The exchange rate of the Hryvnia to the USD has been moved in a very narrow band throughout the year, ranging from only 5.30 to 5.33 Hr to 1 USD. Between the first and second round elections, the black market rate was rumored to have devalued to nearly 6-7 Hryvnia to 1 USD. The NBU only allows banks and other official currency dealers to fluctuate only two percent on either side of the "official" exchange rate of 5.31. As a result of this band, and the general belief that the real exchange rate might now be overvalued, many banks simply refused to sell foreign currency or only sold small amounts.

3. Actions Taken by the National Bank of Ukraine

The National Bank's actions in response to the government's politicizing the financial sector initially seemed to be somewhat harsh, when compared to the amount of "run" on bank deposits. Aggregate figures indicated that the banking sector lost only 3-4 percent of deposits. However, aggregate figures were misleading as domestic banks were experiencing a "run" on deposits, while foreign banks were experiencing a significant influx

The NBU's Acting Governor met with the heads of the largest commercial banks and developed a strategy of communication and confidence building measures, in addition to restrictions and controls on depositor withdrawals. The NBU established "stabilization" lines with the major banks to compensate for the loss of deposits. These were similar to discount window operations, with more stringent terms for collateral. The NBU also imposed controls on the banking system, setting maximum daily and monthly withdrawal amounts for individual and corporate accounts. In the early days of controls, lines could be seen at ATM machines, and many banks limited depositor withdrawals to an amount well below the National Bank's imposed maximum. The panic in the market slowly subsided and all banks have now repaid the full amount of stabilization loans.

We advised the NBU to develop plans for multiple liquidity insolvencies of small banks, and will need to assess the abilities of the deposit insurance fund to handle multiple failures and payouts. Further, the NBU needed to make decisions on which banks were suffering from a "temporary" liquidity crisis versus those that might already be liquidity and capital insolvent.



**UKRAINE – NATIONAL BANK OF UKRAINE
BANKING SUPERVISION DEVELOPMENT PROJECT**

FINAL REPORT

APPENDIX C

SUMMARY OF LEGAL ADVICE

Prepared by

**Gary A. Gegenheimer
Senior Attorney, Emerging Markets Sector
BearingPoint, Inc.**

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Other legal-related memoranda and recommendations to the NBU, included separately.

Date	Subject
May 20, 2003	Share Repurchases
May 28, 2003	Beneficial Ownership
May 30, 2003	Audit Provisions of Banking Law
June 27, 2003	Bank Audit Committees
June 3, 2004	Penalties
June 15, 2004	Consolidated Supervision (Preliminary)
June 23, 2004	Bank Corporate Governance
April 28, 2005	Liability of Supervisory Council Members for Damage to Banks
June 2005	Concept Paper on Consolidated Supervision
June 30, 2005	Legal Protection for NBU

Table of Recommended Law Changes

1. Introduction

The legal component of this project has focused on three areas:

1. Beneficial owners /essential participants of banks
2. Bank corporate governance
3. Consolidated supervision of banking groups

The NBU had planned to introduce amendments to the Law on Banks and Banking Activity (Banking Law) in each of these topics in separate “tranches.” The material on beneficial owners was submitted to the Verkhovna Rada in mid-2004 but was withdrawn for further work when substantial opposition arose over the penalty provisions (see discussion below).

The material on bank corporate governance was supposed to have been submitted to the Verkhovna Rada in the fall of 2004, but this submission was postponed due to the Orange Revolution. These amendments, and the amendments on consolidated supervision, are still being prepared.

Originally, plans were to submit the proposed amendments to the Verkhovna Rada by the end of 2005. However, recently the advisors learned from the NBU Legal Department that the strategy has changed. Current plans are not submit the material on beneficial owners to the Rada until sometime in 2006, following the next round of Parliamentary elections. The reasoning behind this strategy is that the current composition of the Rada is not “reform-friendly,” since the Rada members were elected prior to the Orange Revolution and many are more sympathetic to the previous regime. The NBU believes that the new Rada membership is more likely to be receptive to progressive financial sector legislation.

The advisors recognize the logic of this approach. Still, in our view, it would be more efficient to submit the proposed amendments as part of a single comprehensive package, rather than in piecemeal fashion. The NBU is considering this approach. In particular, the concepts of beneficial ownership and consolidated supervision are inextricably intertwined, and cannot be segregated in a meaningful way. It is somewhat easier to carve out the corporate governance material, but even this would be more efficiently presented as part of a package, since corporate governance of bank holding companies is an important part of the consolidated supervision concept. In addition, transparency of ownership is a key component of both consolidated supervision and corporate governance. The disadvantage of the comprehensive package approach, of course, is that if the Rada members find one aspect of the package objectionable, it could sink the entire legislative effort.

Each of these items has been the subject of extensive recommendations and explanations over the past 3 years. In formulating our recommendations, we have relied primarily on EU Directives, Basel Committee documents, and legislation from Basel Committee countries. The relevant memoranda and comparison tables containing the recommendations, and reasons for

them, are included as attachments to this report. Thus, we will not repeat all of that material here. Instead, we will simply summarize the high points.

2. Areas of Concentration

2.1 Beneficial owners

2.1.1 Definition

One of the major issues facing the NBU is identifying the actual (as opposed to legal/nominal) owners of banks. The “essential participation” definition gives the NBU the authority to approve any person who proposes to own, directly or indirectly, 10 percent or more of a bank, or will be able to exert a “decisive influence” over the bank.¹ This seems to give the NBU the authority it needs in this area. Nevertheless, there is a perception that more is needed, and this approach is not unreasonable. The desire is to give the NBU the authority to determine whether a person has the ability to realize the benefits of share ownership in a bank, even if the nominal or legal ownership may be with another person.

We have proposed the addition of “beneficial owner” based primarily on a similar definition in the Canadian Bank Act:

“Beneficial owner” means a person who has the ability to realize the benefits of share ownership in an entity, through any contract, arrangement, agreement or understanding with another person, whether written or unwritten, formal or informal, even if legal ownership of such shares is with another person.

2.1.2 Investigations of suspected violations

Along with the revised definition, two other areas in particular need attention. First, the NBU needs to have the authority to investigate suspected violations of the requirement that essential participants receive prior approval of the NBU.

Article 72 now provides, in relevant part:

The National Bank of Ukraine has the right to inspect entities subject to National Bank of Ukraine supervision in order to check for compliance with the legislation on banking activity. In the course of these inspections, the National Bank of Ukraine has the right to demand any information from these persons needed for the inspection. The persons being inspected shall submit to the National Bank of Ukraine the required information within the period of time defined by the National Bank of Ukraine.

¹ The “decisive influence” terminology is more appropriate for determining “control” rather than “essential participation.” We have recommended changing the reference to “significant influence” for purposes of determining essential participations. This would be consistent with EU banking directives.

The persons that can be subject to inspection by the National Bank of Ukraine include:

A holder of an essential participation in a bank, if the National Bank of Ukraine believes, that this person (entity) does not meet the requirements set forth in this Law as for essential participation holding or negatively impacts the bank's financial safety and soundness.

A person who acquired an essential participation without the National Bank of Ukraine written permission.

This suggests that the NBU must have already determined that a person holds an essential participation before it can carry out inspections of that person. The problem is that the NBU might *suspect* that a given person has become an essential participant without NBU approval, but might not have the concrete proof needed to make a final determination. Thus, the law should provide that where the NBU is aware of facts that may suggest this, it can investigate the situation. We have proposed the following provision:

The National Bank of Ukraine has the right to require the submission of information from any person, entities controlled by such person or with whom (which) this person has close links, as well as other persons who may have relevant information, if the National Bank of Ukraine becomes aware of facts or circumstances indicating that this person may have acquired an essential participation or control in a bank, or exceeded the ownership benchmarks in Part 1 of this Article, without obtaining the prior permission of the National Bank of Ukraine as required by this Law.

2.1.3 Penalties for Unauthorized Control or Essential Participations

In the event that a person is found to have become an essential participant in a bank, or a beneficial owner of more than the requisite threshold of bank shares, without NBU approval, there need to be severe penalties.

The current provisions of the Administrative Code and Criminal Code do not provide effective deterrents to violations of banking legislation, and they do not directly address unauthorized control or essential participations at all. For example, Article 166(5) of the Administrative Code stipulates that violations of banking legislation by managers of banks and other persons may be punished by a fine of 50 to 100 non-taxable minimum salaries of citizens, which is approximately U.S. \$150 to \$300. Clearly, this does not even remotely correspond to the damage that can result from these violations. Article 202 of the Criminal Code authorizes the imposition of a fine of 200 to 500 non-taxable minimum salaries (U.S. \$600 to \$1500) for participation in unlicensed banking activity, but this only becomes applicable in the event that the unlicensed activity results in a large profit (defined as more than 1000 untaxed minimum salaries, or approximately U.S. \$3,000). Obviously, this is not an effective penalty, because the maximum monetary fine is less than the amount that must be illegally realized in order to make the penalty applicable.

In recognition that the banking business must only be engaged in by persons who can meet very high standards of integrity and trustworthiness, the NBU should vigorously advocate for changes

to the criminal and administrative codes, to substantially increase the penalties for unlicensed banking activity, as well as for acquiring control or essential participations in banks without NBU approval. Please refer to our June 2004 memorandum on penalties for more detailed information.

The original version of the proposed Banking Law amendments contained provisions amending the Administrative Code and Criminal Code, to impose substantial penalties for unauthorized control over banks. These amendments were withdrawn after substantial opposition was expressed in the Verkhovna Rada to the idea of such penalties. The problem, of course, is that a number of Rada members are the nominal (or, more to the point) *de facto* beneficial owners of banks, and they do not want these relationships disclosed. The current plan is to concentrate on passing the portions of the package that can be passed as soon as possible, and to revisit the penalty issue later.

2.2 Bank Corporate Governance

The second area of concentration has been corporate governance in banks.

Corporate governance in Ukraine has been an important topic for several years. With regard specifically to banks, a number of issues are present.

In 2004, the International Finance Corporation completed a *Survey of Corporate Governance Practices in the Ukrainian Banking Sector*. The survey summarizes certain key issues in bank corporate governance and recommends a number of ways in which they could be improved. The following points from the *Survey* are noteworthy:

- In the banking sector, the relevant legislation is nearly compliant with all relevant European Union Directives. Still, many banks cited ineffective banking legislation as one of several key barriers to improvement in corporate governance.
- Banks are generally aware of sound corporate governance principles; however, a number of banks have stated that recommendations of key international organizations (such as Basel Committee and OECD) are incorporated into their internal procedures and documents mainly for compliance purposes. They have often reacted to pressure from regulatory bodies such as the NBU rather than progressively acting on their own.
- Legal requirements are one of the main “drivers” for improvements in corporate governance practices.
- Most banks are in compliance with current legal and regulatory requirements with regard to governing bodies. However, the internal organization of supervisory councils barely meet international standards. Moreover, there is a lack of clarity in the separation and formalization of duties and responsibilities, which in turn is the reason for other shortcomings in supervisory council practices in Ukrainian banks. A more precise positioning of the supervisory council, both in legislation and in the perception of the

business community, needs to be addressed in the further development of corporate governance practices in the banking sector.

To address this situation, the legal advisors have recommended a number of changes to the Banking Law to reflect modern corporate governance principles. These proposals are summarized in a May 2003 memorandum on bank audit committees, a June 2004 memorandum on general corporate governance recommendations, and our Table of proposed amendments.

First, the law should be clear that the supervisory council of a bank is ultimately responsible for the sound and prudent management of the bank. Traditionally, the management of a bank, and in particular the director, tends to make most of the important decisions. Members of the council tend to take a passive role, often serving on the council for “prestige” or because they are willing to help the bank satisfy the legal requirement that it have supervisory council. One of the findings of the 2004 IFC survey was that current Ukrainian banking legislation and regulations do not specify clearly enough the role and professional qualifications of the supervisory council. In many banks, there is a blurring of responsibilities between the shareholders’ meeting, the supervisory council and the management board. In modern corporate governance practice, however, the ultimate responsibility for the proper management of an enterprise, including a bank, rests with the supervisory council. While it is perfectly appropriate to assign the duty for performing the day-to-day functions to full-time senior managers and other employees, it is the obligation of the supervisory council to take adequate steps to make sure that the required tasks are carried out correctly through the adoption of adequate policies, procedures and internal controls. Where deficiencies are noted, it is the responsibility of the supervisory council to see that they are corrected.

The Banking Law does not specifically state this principle. On the other hand, there are a number of provisions in the Banking Law that conflict with it. These provisions should be amended at the earliest opportunity.

Next, the law should expressly require each bank to have suitable risk management policies and procedures. In a very real sense, corporate governance is ultimately about risk management. Banks are in the business of taking risks, yet they utilize other people’s money (mainly in the form of deposits) in their activities to a much greater degree than ordinary business enterprises. How banks manage their risk, and more specifically managing risk in a way that protects depositors, is thus vitally important. Indeed, most banks that participated in the IFC survey identified improving risk management as one of the principal goals of corporate governance.

Currently the Banking Law mentions risk management only in one place, Article 44, and this pertains to the establishment of a standing committee on risk management, rather than to the concept of risk management and components of a good risk management program. It does not mention where the responsibility is for approving the bank’s risk management policies and ensuring their effective implementation. This responsibility should clearly and explicitly be on the supervisory council.

Finally, the enforcement measures applicable to bank managers should be strengthened considerably.

The external audit process is intimately related to corporate governance. The provisions of the Banking Law constitute an adequate base, but more is needed. We have provided some suggestions that would bring the audit – related provisions of the Law into closer harmony with international practice. Please refer to our May 2003 memorandum on this point.

2.3 Consolidated Supervision

Another major issue entails consolidated supervision of banking groups.

Ukraine is actually one of the more progressive of the former Soviet republics in this area, in that the Banking Law contains provisions on bank holding groups and financial holding groups. The problem, however, is that the Banking Law is long on form and short on substance: it contains specific provisions on the creation and registration of such groups, and the legal relationships between the various component entities of these groups, but is completely silent on the critical issue that these groups pose for the bank supervisor: namely, the ability to assess the risk that such groups can pose to the component banks in the group, and the authority to mitigate any risks that the bank supervisor deems to be excessive.

The legal advisors have provided an introductory memorandum and a more detailed draft concept paper on consolidated supervision principles, both of which are attached. The recommendations of these documents can be summarized as follows:

- The law should define a “group” of companies as a parent company and all of its subsidiary and “dependent companies.”²
- The law should contain specific “parent” and “subsidiary” definitions, which should be written in terms of “control” rather than formal ownership. That is, a “parent” company should be defined as any legal entity that “controls” another legal entity. A “subsidiary” should be defined as any legal entity that is “controlled by” another legal entity.
- A “banking group” should mean any “group” of companies that contains a bank as parent or subsidiary company.
- A “Level 1” banking group” should consist of a bank, its subsidiaries and dependent companies, and possibly the bank’s immediate parent holding company, if it is a financially-oriented company. Banks should be permitted to have only financially-oriented companies as subsidiaries and dependent companies.
- A “Level 2” banking group should be wider, and should consist of a bank holding company, and all of its subsidiaries and dependent companies, whether financial or non-financial.

² In accounting terminology, this would be called an “associated company.” The “dependent company” terminology is used in most former Soviet republics, including Ukraine, and typically refers to a company in which another company directly or indirectly owns at least 20 percent of the capital or voting shares.

- A “bank holding company” should be defined as any legal entity that controls a bank.
- A “financial holding company” should be a bank holding company, the subsidiaries of which are mainly or exclusively financial institutions.
- A “financial banking group” should be a banking group headed by a financial holding company.
- A “mixed activity holding company” should be a bank holding company, the subsidiaries of which are not mainly or exclusively financial institutions.
- A “mixed activity banking group” would be a banking group headed by a mixed activity holding company.
- All managers of bank holding companies (whether financial or mixed-activity holding companies) should have to have an impeccable business reputation and sufficient business experience to perform their duties.
- All banking groups (whether Level 1 or Level 2) should be required to have group-wide systems of risk management and internal controls satisfactory to the NBU. These systems should be subject to at least annual review by the NBU, and the NBU should have the authority to require changes if necessary. The bank or “ultimate” parent bank holding company at the head of each group should be responsible for developing such systems for the entire group and ensuring their effective implementation.
- The NBU should have the specific authority to establish prudential normative requirements, especially capital adequacy requirements and large exposure limitations, for “Level 1” banking groups. With regard to wider (“Level 2”) banking groups, the NBU does not need to impose specific numerically-oriented requirements. The NBU should, however, have the authority to review the group’s internal policies in these areas, and to require revisions to these policies if the NBU determines that they are not adequate to protect the bank members of the group.
- The enforcement provisions should be strengthened. In the event that the condition or activities of any component entity of a banking group is determined by the NBU to be possibly detrimental to the bank, the NBU should have the authority to require that entity to correct the situation in a manner acceptable to the NBU. If such steps are not taken, or prove to be unsatisfactory, the NBU should have the authority to require the termination of the relationship between that entity and the bank.
- All significant component entities of a banking group should be required to have an annual external audit. “Significant” entities would include the bank, the bank holding company, and any subsidiary or dependent company that either: 1) generates more than 5% of the revenue of the bank or bank holding company, or 2) comprises more than 5%

of the consolidated total assets of the bank or bank holding company. All component entities of the group should be required to have the same external auditor. In the event that a component entity of the group is given a “qualified” or otherwise adverse opinion by an external auditor, that entity should be required to take specific steps, satisfactory to the NBU, to remedy the situation. If such steps are not taken, or in the judgment of the NBU, prove to be inadequate, the NBU should have the authority to require the termination of the entity’s relationship with the bank.

- In accordance with the Memorandum on Cooperation and Coordination of Activity Between State Bodies that Regulate Financial Services Markets, the various financial sector supervisory bodies should exchange information and coordinate their supervisory activities with regard to different kinds of financial sector entities that are component members of the same group. Areas of focus should include identification of the structure of each group, including the ultimate controlling persons and managerial personnel who effectively direct the business of the group; the group’s business and strategic policies; the financial situation of the group; the organization, risk management and internal control systems at the group level; adverse developments within the group that could seriously affect other regulated members of the group; and enforcement measures taken with regard to any component entity of the group. To the extent that there are any legal impediments to the exchange of information concerning these points among the financial sector supervisory authorities of Ukraine, those provisions should be changed.

2.4 Legal Protection for the NBU

In its most recent (2002) Basel Core Principles Assessment, an FSAP team, consisting of representatives from the World Bank and International Monetary Fund, found that Ukraine is materially non-compliant with Principle 1(5), concerning legal protection for bank supervisors. The basis for this determination was that although the Law on the Civil Service offers some protections, it appears that supervisors are concerned about the legal (and other) risks they run in performing their duties.

We understand that there have been no instances in which NBU employees have been sued personally for actions taken in the course of their official duties. In fact, there appears to be virtually no possibility that an NBU employee could be required to pay damages out of his or her own pocket for such actions. Under Article 1172(1) of the Civil Code, legal entities are obliged to indemnify for the damage inflicted by their employees during performance of their official functions. Similarly, Article 1174 provides that damage inflicted to a physical or legal person as a result of illegal decisions, actions or inactivity of the official of the state government, shall be indemnified by the state irrespective of the guilt of this official. These sections seem to provide sufficient protection for individual NBU officials and employees.

Still, 2 issues are cause for concern:

- 1) potential institutional liability of the NBU itself for supervisory decisions that are determined to be invalid by a court; and

- 2) potential liability of provisional administrators and liquidators of banks (who might not be NBU officials or employees, and thus not covered by Articles 1172 or 1174 of the Civil Code).

To address these issues, we provided a new article for the Banking Law, which could be placed either in the Law on Banks or the Law on the NBU. Please refer to our June 30, 2005 memorandum on this issue for more detailed information.

3. Additional observations and suggestions for future assistance

The National Bank of Ukraine clearly has come a long way since USAID began providing technical assistance in banking supervision nearly 10 years ago. Nevertheless, the journey is far from complete. A number of steps must be vigorously pursued if Ukraine is to have a world-class financial sector supervision program that is on par with the countries of the European Union and other Basel Committee member countries.

3.1 Increased Harmony with EU Standards

The NBU should continue its efforts to bring Ukrainian banking sector legislation into increased harmony with EU and other international standards. We understand that there is currently an EU TACIS project that is assisting the NBU in this area, and this is a welcome step.

In undertaking this effort, the NBU should keep in mind that the primary purpose of the EU banking directives is not to provide a comprehensive “code” for banking regulation and supervision, but to create certain minimum standards with the goal of promoting free trade in banking and financial services throughout the EU Member States. Specifically, this entails licensing and supervision of banks in their respective home countries, with certain aspects of those items being harmonized throughout the EU, so that a bank licensed in one Member State will be free to provide banking services throughout the EU under cooperation between the home and host country supervisors. The directives comprise a set of *minimum* standards, which have been implemented in different ways in different EU Member States. An examination of the banking legislation of EU Member States reveals that seldom are the directives’ provisions incorporated in total, and seldom do the Member States confine their legislation to the contents of the directives. The Member States have often varied the precise wording of the directives while retaining their substance (and, in many cases, have adopted stricter and more comprehensive requirements). The provisions of the directives are quite valuable, and on some topics perhaps even sufficient, but they are far from exhaustive.

The NBU should therefore look beyond the precise language of the EU directives and utilize the internal banking legislation of other countries, both European and non-European. In doing so, the NBU will need to examine the legislation of individual countries with a critical eye, to determine which countries’ laws provide the best models for implementing the spirit of the EU and Basel Committee principles. The EU Member States are in very different stages of development, ranging from Germany, France and the U.K. on one end to the recently-admitted former Soviet bloc countries of Eastern Europe on the other. In our experience, the banking laws of Germany, Estonia, Croatia, Canada, the United States, and Australia are particularly

good supplements to the EU directives. In our table of recommended amendments to the Banking Law, we have utilized these laws extensively.

Recommendation: The NBU should continue to seek international legal expertise to assist it in updating its banking legislation and making it more compatible with international standards. USAID should consider providing further assistance to see that this goal is achieved.

3.2 Supervisory Judgment and Discretion

Financial sector supervision is radically different today than was the case twenty years ago. Banking activity is much more complex and increasingly difficult to analyze. Technological improvements have made it possible to move money faster and further, and involve more market participants, than at any time in history. Banks engage in increasingly sophisticated transactions and lines of financial business, and are often affiliated with other companies (both financial and non-financial) under the same corporate “umbrella.” As a result, it is no longer sufficient to build a financial sector supervision program around compliance with relatively simple rules. Modern financial sector supervision is more judgmental than mechanical, more art than exact science. Bank supervisors need to understand banking risks, and monitor these risks, being vigilant to prevent those risks from becoming excessive or uncontrollable. This is particularly important when a country offers a deposit insurance program. A government-sponsored deposit insurance program adds a new burden to the role of banking supervision.

The legislation under which modern banking supervisors operate must reflect this necessity, and must give the banking supervisors an appropriate amount of discretion to take supervisory action that they deem necessary to protect depositors.

Recognizing these realities, most EU and Basel Committee countries have written their banking legislation in ways that will maximize the opportunities for the use of discretionary judgment of the bank supervisor, rather than stressing compliance with specific rules.

In its *Core Principles for Effective Banking Supervision*, the Basel Committee cautions against mechanical application of quantitative criteria, and urges countries to allow their supervisors to make discretionary determinations based on judgment. The Committee points out that:

“[B]anking supervision is a dynamic function that needs to respond to changes in the marketplace. Consequently supervisors must be prepared to reassess periodically their supervisory policies and practices in light of new trends or developments. *A sufficiently flexible legislative framework is necessary to enable them to do this.*”³

Indeed, the supervisor’s legal authority to apply qualitative judgment is so critical to effective bank supervision that it is specifically mentioned as one of the Basel Committee’s “essential criteria” for determining whether a country is in compliance with the *Core Principles*.⁴

³ Basel Committee, *Core Principles*, page 10 (emphasis added).

⁴ See *Core Principles Methodology*, page 13, Principle 1(4) (“Suitable Legal Environment”), Essential Criteria, Point 2, and page 25 (addressing Core Principle 10 on “connected lending”), Essential Criteria, point 1.

The Basel Committee had stressed this concept even prior to the promulgation of the *Core Principles*. In its September 1994 *Report on International Developments in Banking Supervision*, the Committee emphasized the need for bank supervisors to have considerable flexibility in overseeing banks:

“As banks move away from traditional activities, supervision becomes more judgmental, requiring an assessment of the appropriateness of an individual bank’s business strategy in light of its management capabilities and of overall market conditions...Increasingly, supervision needs to find solutions for complex risks along the lines being developed by the market leaders.

“Supervisors in the emerging markets are subject to very similar challenges, albeit at a less advanced stage of development. As banks are allowed to engage in a wider range of activities, or non-banks encroach on the traditional banking turf, and as controls on market mechanisms such as interest or exchange rates are gradually lifted, supervision becomes more important and more complex. *Attention has to be paid more to management capacity and to qualitative aspects of a bank’s performance than to straightforward quantitative criteria.*” [emphasis added.]

More recently, the Basel Committee has noted:

“Legislation frequently adopts a rules-based approach. However, it is also helpful if the legislation permits the supervisor to exercise discretion in the deployment and timing of supervisory tools.”⁵

The message of the above passages is clear: In order to implement a world-class financial supervision program, the NBU must have the legal authority, the substantive knowledge, and the political willingness to exercise *judgment*, and to make difficult determinations on the basis of its critical analysis and evaluation of facts that do not always present obvious answers. In other words, the NBU must be willing to look beyond simple form and make decisions based on substance.

This is only partly a legal problem. That is to say, in some cases, the text of the Banking Law unquestionably needs to be updated to give the NBU broader authority to make these kinds of qualitative judgments. But in other areas, the Law already gives the NBU considerable room to exercise judgment and to make discretionary determinations; the problem is that the NBU has tied its own hands in the regulatory provisions or actual practice that it has adopted to implement those legal provisions.

To take one example, the Law states that all holders of essential participations in bank, and all bank managers, must have an “impeccable business reputation.” This is quite consistent with the legal standards found in the banking legislation of Basel Committee countries (analogous to the “fit and proper” test in the U.K., “trustworthiness” in Germany and so forth). Unfortunately, the

⁵ See Basel Committee, *Supervisory Guidance on Dealing With Weak Banks* (March 2002), page 6.

NBU's own licensing regulation removes any room for analysis and judgment. Under this regulation, a person is considered not to have an impeccable business reputation only if:

- he has been convicted of a criminal offense; or
- he has been subject to a mandatory order of the NBU requiring his removal from his position in a bank (in practice an extremely rare occurrence).

Obviously, these criteria are susceptible only of mechanical application. But in order to properly supervise banks, the NBU must be able to do more than “check items on a list.” Briefly stated, the NBU needs to have the ability to review and analyze the applicant's previous business and work experience and make a good-faith determination as to whether this person can be trusted in a position that allows him to make decisions involving enormous amounts of other peoples' money.

One of the better statements of the “fit and proper” principle can be found in the *Guidance Paper for Fit and Proper Principles and Their Application*, published by the International Association of Insurance Supervisors (“IAIS”). We recommend that the NBU study this document carefully. The IAIS notes that a determination of fitness and propriety entails a determination of, among other things, a person's diligence and soundness of judgment, and whether the person has been engaged in any unsatisfactory business practices (whether unlawful or not). The IAIS suggests that in order to make this determination, the supervisor should have the legal authority to obtain and evaluate information such as, for example, whether a given applicant has ever:

- been disqualified from engaging as a director or manager of any financial organization;
- been refused (or had revoked) a license or authorization to carry on any regulated financial business, or to engage in any profession or occupation where such a license or authorization is required (for example, the legal and accounting professions typically require such authorizations);
- been subject to censure or disciplinary action by any governmental, regulatory or professional oversight body;
- been involved in any litigation, especially litigation that may suggest dishonesty or fraud;
- been dismissed from office or employment, or subject to any disciplinary action by an employer;
- been a director, officer, manager, or significant shareholder of any company that has been investigated for legal violations or improper business practices.

While an affirmative answer to any of the above questions need not automatically disqualify a person from holding a given position, it would raise serious questions which would need to be pursued further, and could form the basis for an adverse determination by the financial sector supervisor about the individual's fitness and propriety.

The same principle also applies to other topics. For example, the Banking Law requires that all “essential participations” of banks must be approved by the NBU. One of the elements of the “essential participant” definition is “direct or indirect” ownership of at least 10 percent of the bank’s shares. In the case of a “chain” of ownership, this provision clearly gives the NBU the authority to proceed all the way “up the chain” until it finds the ultimate person or entity that would be the essential participant. We have been informed, however, that in practice the NBU does not look beyond the second “tier” of ownership when assessing a prospective essential participant. Obviously, this creates an artificial “road block” for the NBU, because it cuts off the NBU’s ability to determine the true beneficial owners and essential participants. It is generally acknowledged that in many Ukrainian banking groups, actual control is exercised at a level several layers above the bank. By only focusing on the first two “tiers” of ownership above the bank, it is easy to miss the actual essential participants – and it is certain that the ultimate beneficial owners of banks are aware of this.

Whether the NBU’s current posture is due to a lack of political willingness to uncover the actual essential participants, or an overly conservative interpretation of the NBU’s legal authority, it is unsustainable if Ukraine hopes to develop a world-class financial sector supervisory regime. A much more pro-active approach is both necessary and legally feasible. Briefly stated, the NBU absolutely must be willing to determine who is ultimately controlling (or significantly influencing) banks in Ukraine; to determine the suitability of such persons; and to take strong action if it determines that any person is exercising such control or influence without the NBU’s approval.

We have also recommended that each bank must have risk management systems and internal controls that are suitable for the bank based on its business activities and risk profile. The NBU should review and evaluate each bank’s risk management system at least annually, and should have the authority to require any changes that it deems necessary. In order to do this, the NBU will need to have the substantive knowledge to be able to recognize the various types of risk to which each bank is exposed, and to critically analyze and evaluate each bank’s risk management system and internal control mechanisms. This is even more challenging when a bank is part of a banking “group,” because the NBU will need to analyze and evaluate the risks, and techniques for management of those risks, in each of the companies in the group (some of which might not be banks, or even financially-oriented businesses), as well as the group as a whole (see above discussion concerning consolidated supervision).

Recommendation: The NBU should continue its efforts to train its staff in the techniques of recognition, analysis and evaluation of banking and financial risk. We believe that it is important that members of the NBU’s legal staff who are involved in providing advice to the banking supervision, licensing and methodology, participate in these training programs. In the future, it is likely that the NBU lawyers will need to defend many NBU decisions in court where those decisions entail the exercise of such supervisory judgment and discretion. The lawyers will be in a much stronger position to do this if they truly understand the substance of the decisions that the NBU must make in its capacity as a bank supervisor. This is examined in more detail in the next section.

3.3 Enhancement of Enforcement Authority

One of the major issues that should be addressed in the Banking Law is improved enforcement authority. The current Law does not contain sufficient authority for the NBU to require corrective measures in banks based on poor management, inadequate risk management, or faulty internal controls.

Currently, the bases for enforcement action under Article 73 are:

- Violations of the banking legislation of Ukraine;
- Violations of regulations of the National Bank of Ukraine; and
- Carrying out risky operations, which threaten the interests of the bank's depositors or other creditors.

The problem is that the list of compulsory measures that the NBU can impose in response to these events does not adequately deal with ineffective risk management or internal controls. For example, point 1 of Article 73, paragraph 1 refers to a "warning" from the NBU, while point 4 refers to "instructions." Although the warning letter can pertain to any violation or situation that may endanger the bank or its depositors, the problem is that it is not a mandatory order or "instruction" that must be complied with. The subjects of "instructions" (point 4) are very specific, and do not address poor management practices, inadequate risk management or internal controls. For example, point 4 contains items such as:

- Suspension of the payment of dividends or distribution of the capital in any other form.
- Imposition of increased economic normatives on the bank;
- Increase in the loan loss provisions and allowances for other assets
- Limitation, termination or suspension of some high risk operations performed by the bank;
- Imposing a ban on the provision of unsecured loans.

The law should be very clear that *any* violation of a relevant law or NBU normative act, or engagement in *any* practice or operation which, if continued, could pose an unacceptable risk to the bank or its depositors, constitutes sufficient grounds for issuance of a compulsory instruction or order by the NBU to remedy the situation in a manner satisfactory to the NBU.

Second, the provisions on removing banks' officials and essential participants are much too weak. Subpoints (g) and (h) of point 4 permit the NBU to issue removal orders, or to prohibit essential participants from exercising voting rights, "temporarily," i.e., until the violation is removed. Although these persons may resume these activities only with the NBU's consent, Article 73 appears to establish a presumption that such approval will be given once the violation has been corrected. The problem is that some violations may be so manifestly bad that the perpetrator should not be given the opportunity for a repeat performance. The presumption should be against reinstatement of the person's position in the bank, or voting rights. Such reinstatement should rarely be approved.

Third, as noted above in the section on essential participations, the monetary penalty provisions are patently inadequate. The maximum penalty under the Banking Law and the Administrative Code – the UAH equivalent of about U.S. \$300 - amounts to nothing more than a “nuisance tax” or a minor “cost of doing business.” Please refer to our 2004 memorandum on penalties for more detailed information.

Recommendations: The Banking Law should be amended to give the NBU the specific authority to issue mandatory orders requiring banks (and other persons subject to NBU authority) to cease violations and practices that could endanger the bank’s stability, and to take affirmative steps, satisfactory to the NBU, to correct the situation.

Orders removing a person from his position in a bank, or depriving him of voting rights or essential participant status, should be presumed to be permanent bans on further participation in the conduct of the affairs of any bank. Reinstatement should be given only in the highly unusual case where the person can satisfy the NBU that he has changed his ways, and will not constitute a threat to the bank or its depositors. Approval by the NBU of such requests should be extremely rare.

The penalty amounts should be greatly increased. The amounts of monetary penalties should correspond to the seriousness of the offense. The Banking Law and/or the Administrative Code should allow the NBU to take into account a variety of factors, such as whether the violation was intentional, was part of a pattern of misconduct, resulted in loss to the bank or benefit to the person committing the violation, and so forth.

3.4 Judicial education/principles of judicial review

Effective risk-based bank supervision cannot be achieved without the support of the judiciary. No matter how well the banking legislation is written, or how much risk analysis training is provided to examiners and financial sector supervisors, their efforts will be hampered if their decisions are second-guessed and reversed by the courts, and there is a much greater likelihood of this happening if the courts do not understand the purposes and functions of financial sector supervision. As pointed out in the Core Principles Assessment, Ukrainian courts are reluctant to give deference to the qualitative judgments of the NBU.

President Yushchenko has stated publicly that the rule of law and reform of the Ukrainian judicial system will be high priorities under his administration. This is a much-needed development, and it provides an excellent opportunity for future assistance in an area that traditionally has not gotten much attention from the donor community: administrative law reform, and more specifically, principles of judicial review of actions of public regulatory and supervisory authorities.

Experience in other countries teaches that courts in transition economies seldom have a good grasp of the concepts of financial sector regulation and supervision. Often, the judges’ training and professional background has emphasized criminal, family and more recently, private commercial matters. They typically have no experience in “administrative law” as that concept is understood in western, market-oriented countries.

Indeed, traditionally, the whole idea of “administrative law” in former Soviet republics was virtually non-existent. In a holdover from the Soviet era, “administrative law” usually refers to a series of legal principles under an “administrative violations code,” which imposes sanctions for various lower level infractions that are less serious than those found in the criminal code. The notions of accountability of governmental authorities, limited judicial review of decisions of public authorities based on the “administrative record,” and judicial deference to the expertise of the regulatory authority, are completely unknown concepts.

Recently, this situation has begun to change, as a number of former Soviet republics, including Ukraine, have adopted “codes of administrative procedure” to handle disputes between private parties and public authorities. Some of these countries have also created specialized administrative courts with jurisdiction to consider these cases.

The Verkhovna Rada of Ukraine passed a new Administrative Procedural Code on July 6, 2005. Pursuant to the Law of the Judicial System of Ukraine (2002), there are also plans to create specialized administrative courts. It is expected that there will be 3 levels: local (first instance) courts, appellate courts, and a Supreme Administrative Court.

Clearly, the adoption of an administrative procedural code is a welcome step. Still, it will have an enormous impact on the effectiveness of financial sector supervision, and could complicate the supervisory process considerably unless certain key principles are clearly established and understood. Specifically, it is critical that Ukraine adopt internationally-compatible standards of judicial review of decisions of public authorities if risk-based supervision is to be successfully implemented.

In a previous era, when a decision of a financial supervisor such as the NBU was challenged in court, the court’s task was relatively simple, because the supervisory task itself was relatively simple; the applicable legal standards were rather mechanical and did not require particularly sophisticated analysis. Thus, in the past, many supervisory actions could be taken based on straightforward applications of purely objective legal criteria, such as numbers, ratios, and straightforward facts. As a result, there was a low probability that those actions could be reversed by a reviewing court, because the legal provisions could only be understood in one way. The legal standards in a risk-based supervisory regime, by contrast, are quite different. By necessity, these standards are more qualitative in nature, requiring the bank supervisor to closely analyze and evaluate facts, and then make a decision which, in its judgment, will be most likely to protect bank depositors and the financial system as a whole.

As we have seen, modern, market-oriented banking legislation is not written in rigid, concrete terms, but instead in rather flexible and imprecise terms (see discussion above). The legislation is purposely written in a relatively indefinite manner, so that the bank supervisor will have the flexibility to critically analyze and evaluate fact situations (which are often quite complex); draw expert conclusions based on that evaluation and analysis; and then apply the supervisory measures which, in its judgment, are most appropriate to allow the supervisor to fulfill its legal mandate of protecting depositors and maintaining the stability of the financial and payment systems.

The Ukrainian Banking Law contains some of these kinds of provisions already. For example, as noted above, the law requires all essential participants in banks and bank managers to have an “impeccable business reputation.” We have recommended including even more of such discretionary standards, such as giving the NBU the authority to determine whether a bank’s internal controls or risk management procedures are “adequate” given the nature of the bank’s operations.

It is critical that the bank supervisor have the legal authority to construe these relatively broad legislative provisions, and to apply these provisions to facts in the manner that the supervisor deems to be most appropriate in view of the law’s purpose. *A necessary corollary to this is that the supervisor’s decisions must be respected by the courts, unless a given decision is patently unreasonable.* For example, the banking supervisor must have the ability, within the bounds of reason and common sense, to determine when a given set of facts amounts to “danger to the financial stability of a bank,” to require corrective action which, in its judgment, will best alleviate that situation, and to have confidence that its decision will not later be annulled by a court based on a different opinion as to the correct understanding of these words and phrases.

This principle is applicable to decisions of any public body whose legal mandate requires the use of critical analysis, but it is particularly important in complex fields such as banking supervision. Banking supervision is a highly technical field which requires the application of specialized expertise, and the blending of data from such disciplines as accounting, financial analysis, collateral valuation, and business risk management. Because bank supervisors are much better qualified than judges to undertake such analysis and to draw such expert conclusions from facts, courts in Basel Committee countries rarely overturn bank supervisory decisions. Instead, the courts give a great deal of deference to the expertise of the administrative agency, and will annul a supervisory decision only in the unusual case where the petitioner can demonstrate to the court’s satisfaction that the regulatory body’s understanding of the law was manifestly incorrect as applied to the given facts.

Of course, if a supervisory body’s pure factual findings are wrong (for example, if the supervisory body bases a decision on inaccurate statistics), the court is entitled to quash the measure. But more often than not, the supervisory body is obliged to assess basic facts and to draw a conclusion under a flexible legal provision. Clearly, for example, a determination by a bank supervisory agency that a bank has engaged in “unsafe or unsound practices” is quite different from simple confirmation of objective facts or financial data. A decision of this kind entails a complex determination consisting of, first, a number of purely factual observations (such as, for example, the factual characteristics of a bank’s credits, the borrower’s income and previous credit history, the contents of the bank’s credit policies, the bank’s level of capital, its earnings trend over a certain period of time, and so forth) and, secondly, an analysis and evaluation of those “primary” or basic facts to determine whether they do or do not amount to an “unsafe or unsound practice.” Questions of this sort do not have clear “right” or “wrong” answers. This evaluation necessarily depends on the supervisory agency’s judgment, exercised on the basis of its experience.

Thus, when reviewing decisions of public bodies that require the exercise of specialized technical expertise, courts in many countries apply the principle of “limited review.” For example, the court does not attempt to determine for itself whether a bank’s business practices are “unsafe or unsound,” or whether the bank’s risk management policies are “suitable” for its risk profile and business strategy. Instead, the court presumes that the supervisory body has correctly analyzed the facts and made an appropriate supervisory decision. In order to overcome this strong “presumption of correctness,” the burden is on the appealing party to clearly demonstrate that the supervisory body has exceeded its authority under the law. To meet this burden, much more than a mere difference of opinion is necessary. The appealing party must clearly show that the agency’s decision was without a rational basis under the standards set forth in the law. The American legal terminology is that the appellant must demonstrate that the public authority’s decision was “arbitrary or capricious;” the analogous French terminology is that the public authority has made a “manifest error in the assessment of facts.”⁶ In either case, the basic principle is that no reasonable public administrator could have reached the given conclusion based on the given facts – in practice a highly unlikely (though not impossible) scenario.

In addition, in many countries, the court’s review of a supervisory body’s decision is limited to the “administrative record,” which is the compilation of documentary materials that the supervisory body considered in reaching its decision. Factual material that was not considered by the supervisory body cannot later be introduced by the appellant or considered by the court. Limiting the court’s review to the administrative record accomplishes two things: first, the court is better able to determine whether there was a reasonable connection between the facts that the supervisory body found and the decision that it made. Second, the court will be less likely to substitute its own evaluation of the facts if its review is confined to the materials that the supervisory body reviewed.

Not only is the supervisory body’s application of indefinite legal terminology entitled to great respect, but the supervisory body is entitled to a broad range of choices in determining what supervisory tool to apply. For example, if two or more kinds of enforcement actions are legally permissible, the court will not substitute its own judgment for that of the supervisory body if that action is appealed. It will not, for example, invalidate a decision revoking a bank’s license and determine that the supervisory body should have used a written order instead, where the underlying facts could have supported either of these alternatives. Said differently, the court does not “take the seat of the supervisor”: it considers only the legality, but not the desirability, of a given action.

Occasionally, of course, a bank supervisory agency might, due to excessive zeal, take action that is *plainly* disproportionate to the offense. In this event, a court might overturn the decision. In European law this concept is known as “proportionality;” the American terminology is that the agency has “abused its discretion.” For the court to overturn an agency’s decision on this basis, however, the action must be more than unpalatable – it must be egregious. Such reversals are extremely rare in Basel Committee countries.

⁶ The French approach to administrative law has become the model for many countries of Continental Europe, as well as for the EU itself.

There is another school of thought, mainly advanced by various human rights advocates, that any final decision of a public authority should be subject to “full review” in the courts, meaning that the court should be able to consider any evidence it deems relevant (whether or not the public authority considered that material), and is not bound by the “presumption of correctness” that characterizes limited review. While this approach is understandable in some areas, in our opinion full review is not practical in a field as specialized as financial sector supervision. Judges simply do not have the technical expertise to engage in full review of decisions of this kind. In highly specialized fields, such as financial sector supervision, limited review is more appropriate.

A cautionary note is necessary: while courts should apply a strong “presumption of correctness” and should accord great deference to supervisory expertise, it is also true that public authorities need to earn the right of judicial deference. Supervisory authorities should not expect the courts to simply take their submissions on faith, or without adequately explaining the connection between the facts they found and the decision they made. There must be a solid administrative record which will provide a good “road map” for the court. While the burden should be on the petitioner in court, the supervisory staff should have the initial burden of convincing the supervisory body’s final decisionmaker that a given action is appropriate and necessary. Hence the administrative record - which will contain that information - is of the utmost importance. It is also necessary that the supervisory staff possess the substantive knowledge and expertise to be able to analyze and evaluate basic facts, assess the risks to which a bank is exposed, and to formulate an appropriate course of supervisory action.

Recommendation

As part of its next generation of assistance, USAID should explore ways to ensure that the Ukrainian judiciary understands, and can properly apply, these concepts.

There are of course many efforts underway in the legal reform and commercial law area in various countries, and these projects can provide some valuable insights. But relying on these projects alone will not accomplish the objective of enhancing the effectiveness of the financial supervisory authorities. Commercial law, by definition, tends to emphasize contractual and property rights as between private parties, rather than the authority of public bodies such as financial sector supervisors. From the point of view of financial sector supervision, the latter category is much more relevant.

The following steps are specifically recommended:

- USAID should undertake a diagnostic study of cases in which decisions of financial sector supervisory bodies have been challenged in court. This will provide a good foundation for assessing the judiciary’s level of understanding of the purposes of financial sector supervision and the role of financial sector regulatory bodies.

- The National Bank and other financial sector supervisors should take steps to ensure that the Administrative Procedure Code reflects the above – referenced principles of judicial review. USAID should consider providing assistance to ensure that this goal is met.
- USAID should provide judicial education specifically in the field of administrative law. It would also be very helpful to provide educational opportunities in the financial area for administrative court judges who are expected to handle cases entailing review of decisions of financial sector supervisory bodies.

4. Conclusion

The Legal Advisors are very pleased to have had the privilege of assisting the NBU over the past 8 years. Much has been accomplished, and much remains to be done.

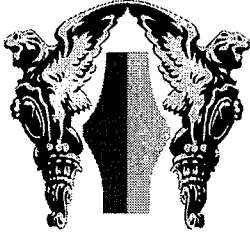
A common perception is that financial sector reform is extremely difficult in Ukraine because of the “cozy” relationships between banks and members of the Verkhovna Rada, many of whom are the official or de facto, undisclosed beneficial owners of banks. This perception is undoubtedly true, yet this should not deter the NBU from seeking strong legal authority to perform its role of promoting a strong banking sector and ensuring the safety of assets entrusted to banks, or utilizing the legal authority that it does have as vigorously as it deems appropriate to carry out its functions. The NBU should vigorously advocate for strong supervisory authority, even if its position might not be politically popular. After all, the NBU is charged under the law with supervising an industry that is in the business of handling - and taking risks with - other people’s money.

Some words of wisdom can be found in the following quotation from Mr. James Landis, former Chairman of the U.S. Securities and Exchange Commission, Dean of the Harvard Law School, and one of the chief architects of much of the early financial sector regulatory legislation in the United States:

“The assumption of responsibility by an agency is always a gamble that may well make more enemies than friends. The easiest course is frequently that of inaction. A legalistic approach that reads a governing statute with the hope of finding limitations upon authority rather than grants of power with which to act decisively is thus common...[T]here is an enormous difference between a legalistic form of approach that from the negative vantage of statutory limitation looks to see what it must do, and the approach that considers a problem from the standpoint of finding out what it can do.”⁷

A final word of advice can be found in the words of Frederick Douglass, who was born a slave in 19th-century America, eventually gained his freedom, and devoted the rest of his life to ending slavery in the United States. During his later years, a young person asked Mr. Douglass what he could do to bring about positive change. Mr. Douglass’ response was clear and simple: “Agitate. Agitate. Agitate.”

⁷ James Landis, *The Administrative Process* (1938)



**UKRAINE – NATIONAL BANK OF UKRAINE
BANKING SUPERVISION DEVELOPMENT PROJECT**

FINAL REPORT

APPENDIX D

SUMMARY OF SEMINARS DELIVERED

Train-the-Trainers Seminar November 2003

##	Title	Date	City	# of Attendees
1	Risk-based supervision	November 10-21	Kyiv	22

Risk-Based Supervision Seminars 2004

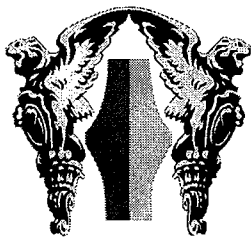
##		Date	City	# of attendees
1.	Risk-based Supervision	February 16-18	Kyiv	22
2.	Risk-based Supervision	March 1-3	Kyiv	14
3.	Risk-based Supervision	April 5-7	Kyiv	15
4.	Risk-based Supervision	March 15-17	Zaporizhzhya	10
5.	Risk-based Supervision	March 23-27	Cherkassy	20
6.	Risk-based Supervision	March 31 – April 2	Dnipropetrovsk	10
7.	Risk-based Supervision	April 19 – 21	Donetsk	12
8.	Risk-based Supervision	May 11 - 13	Lviv	35
9.	Risk-based Supervision	May 24 – 26	Kharkiv	31
10.	Risk-based Supervision	June 2 - 4	Crimea	30
11.	Risk-based Supervision	June 7-9	Odessa	28
12.	Risk-based Supervision	September 13-15	Lviv	42
13.	Risk-based Supervision	September 27-29	Luhansk	27
14.	Risk-based Supervision	October 4-6	Lviv	32
15.	Risk-based Supervision	October 11-13	Sumy	18
16.	Risk-based Supervision	November 8-10	Kharkiv	28
	TOTAL			374

Risk-Based Supervision Seminars 2005

##				
1	Risk-based supervision	January 31 – February 2	Kyiv	35
2	Risk-based supervision	February 21 - 23	Kyiv	37
3	Risk-based supervision	March 23-25	Dnipropetrovsk	20
4	Risk-based supervision	April 20-22	Lviv	30
5	Risk-based supervision	May 18-20	Odessa	20
	TOTAL			142

Other Training Events Organized And Conducted By Bearingpoint For The National Bank

##		Date	City	# of attendees
1.	Risk-based supervision and credit risk management (delivered by the National Bank of Poland)	September 6-9, 2004	Kyiv	41
2.	Consolidated Supervision (Roundtable)	April 14, 2005	Kyiv	44
3.	Consolidated Supervision - International experience (Roundtable)	April 18, 2005	Kyiv	34
	TOTAL			119



**UKRAINE – NATIONAL BANK OF UKRAINE
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FINAL REPORT

APPENDIX E

**ACTION PLAN FOR IMPLEMENTATION OF
RISK-BASED SUPERVISION**

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1. Enhance the Supervisory Cycle / Supervisory Strategy Document

The Banking Supervision Department (“BSD”) should amend the policy defining the *supervisory cycle* for banks in Ukraine. The supervisory cycle is defined as the time between the ending date of a full scope, on-site inspection and the start date of the next inspection. The supervisory cycle should be primarily related to two factors. First, the supervisory cycle should be related to the amount of risk that an individual bank or banking group poses to the entire banking system in Ukraine (systemic risk). This systemic risk generally refers to banks with the largest market shares of assets, loans and deposits, and those banks that have the most complex product lines. Secondly, the supervisory cycle should be related to the individual risk in a bank. This is most closely related to the institution’s CAMELS rating and its risk assessment. We should note that the supervisory cycle refers to a full-scope, on-site inspection of the bank, as a whole, not individual branches within the banking organization. Branches should be inspected on an as-needed basis, not based on any cycle. Also, the supervisory cycle is considered the maximum amount of time between inspections, not the minimum amount of time. If a bank with systemic risk implications for Ukraine is also showing a severe financial weakness, it might be prudent to inspect the bank using a six-month supervisory cycle.

Institutions with high levels of system risk and those with high individual risks should have shorter supervisory cycles than institutions with lower levels of risk. For instance, all banks in groups one and two in Ukraine and all banks with a CAMELS rating of 3, 4 or 5 might be assigned to a category requiring a full-scope, on-site inspection every 12 months. All banks with a CAMELS rating of 1 or 2 and with a “high” aggregate credit risk or a “high” aggregate liquidity risk assessment might be assigned to a category requiring a targeted, on-site inspection every 12 months. Finally, all remaining banks might be assigned to a category requiring a full-scope, on-site inspection every 24 months. After approving a policy statement defining the supervisory cycle for each bank in Ukraine, each bank in Ukraine should be assigned to one of these three supervisory cycle categories. As the banking system stabilizes, and risk management systems and financial reporting improve, the BSD might consider a 36-month supervisory cycle for banks in groups three and four with CAMELS ratings of 1 or 2.

The BSD will next need to develop a supervisory strategy document for each bank. The initial format of this document has already been developed the BSD Methodology Unit. This document must detail all planned supervisory actions (including an estimate of the amount of estimated human resources for these actions) for each bank through, and including, the next full-scope, on-site inspection. Once assigned to a supervisory cycle, the BSD should complete a supervisory strategy for each bank. The first set of strategies will need to be completed at one point in time, meaning the overall accuracy of estimates will be less than perfect. On an ongoing basis, the on-site inspectors should develop this document with cooperation from the assigned off-site analysts, at the conclusion of each inspection.

The supervisory strategy should include, at a minimum: the number of inspectors to be involved at the next comprehensive on-site inspection, the time estimate for the next

inspection, the number and location of branches to be reviewed, the number of persons needed (including any necessary risk area specialists), timing for the head office review, and the overall scope of the inspection by risk category. It is not necessary to list personnel by name, only by levels of expertise and specialty. We realize that given the volume of turnover in the BSD inspection unit at the present time, it is difficult to plan for the next inspection. The strategy should also include any targeted on-site inspections in between full-scope inspections.

The off-site analysts should confirm the accuracy of the strategy document each quarter relative to the bank's actions taken in response to the previous inspection as well as the current trends and risks noted from analysis. This process may necessitate that the off-site analysts attend each on-site inspection to more completely understand the bank's conditions and expectations that the on-site inspectors have for the bank in the interim period between full-scope inspections.

The supervisory strategies will form the basis for allocating resources and for general planning in the banking supervision area. By compiling all supervisory strategies, the BSD can more easily determine the number of inspectors and analysts needed for inspections and follow-up analysis. For staff size planning purposes, the BSD should also consider vacations, sick leave, and training opportunities for all supervisory staff.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Approve policy statement for supervisory cycle.			
2. Approve supervisory strategy document format.			
3. Develop instructions for use of supervisory strategy document.			
4. Assign all banks to a supervisory cycle category.			
5. Develop a supervisory strategy for every bank.			

2. Improve Inspection Planning Processes / Allocation of Resources

The BSD seems to have an adequate number of staff to perform the role of banking supervision. However, the staff does not seem to be mobile and are not located in the geographic areas of highest need. Additionally, the inclusion of certain persons with the on-site inspection team, who may not be performing work directly related to risk-based supervision, detracts from the inspection team's efficiency. These issues are creating inefficiencies in supervision operations, which impact the BSD's ability to conduct effective risk-based supervision.

One of the causes of these inefficiencies seems to lie in the policy of inspecting branches. The geographic location of bank supervision staff seems to drive the inspection process, rather than the risk profile of the commercial banks to be inspected. Further, the regional offices of the NBU seem to be somewhat independent in their inspection processes, rather than driven by a single, supervisory strategy regarding the effected bank.

Branches of commercial banks should only be inspected if they pose a significant risk to the bank's risk profile and should have a much more limited inspection scope than that of the head office location. Inspections of branches should only occur in the branches having the most active loan portfolios, or branches with certain risk exposures that could affect the entire banking group. The most important risks in branch offices are credit risk, operational risk and, to a more limited extent, reputation and legal risks. Branch reviews might also include testing the implementation effectiveness of policies issued by the bank's head office or for significant internal or external audit weaknesses. All market-related risks (liquidity risk, interest rate risk, foreign exchange risk, price risk) and legal and strategic risks should be managed at the commercial bank's head office and therefore inspected there as well. Decentralized risk management of market risks is generally not a good risk management practice for banks. Nonetheless, if risk management of market risk is decentralized, more work will be necessary in branch locations. Regardless of general branch inspection methodology, it is important to follow the approved supervisory strategy for the individual bank. A branch inspection is not justified simply because the National Bank has bank supervision staff nearby.

The inspection process should start with a small team in the head office learning the bank's strategic direction and overall risk profile. This team will be comprised of the team leaders for risk areas and will be responsible for developing the plan for inspection of branches. After the head office team has determined the risks to be addressed and the inspection plan for addressing those risks, the branch teams should commence their inspections according to this plan. The branch inspection findings will then be discussed with the bank's branch manager, and sent to the head office location in a format determined by the inspector-in-charge. The full review of the head office will only begin near the conclusion of the branch offices reviews. Key personnel from the inspections of branches might be useful as part of the head office inspection team as well. The most significant conclusions of the branch reviews will be consolidated into the report of inspection for the head office.

It is important to appropriately staff the head office locations for inspections, particularly of the more complex banks, with an appropriate number of inspectors and with inspectors that have the proper expertise to deal with the most complex risks. In this realm, the BSD will likely need to "borrow" the best persons from regional offices to work at the head office locations on a temporary basis from time to time. It is not economically feasible, in the short term, to ask people to relocate on a permanent basis from the regions to Kyiv. However, in the long term, the National Bank should consider a program to provide more incentives (monetary or otherwise) to attract more people to the BSD Head Office and Kyiv Regional Office. A critical issue to the long-term viability of banking supervision function is the ability to attract and retain quality employees, stopping the

curtain outflow of experienced and well-trained inspectors to the banking industry. This issue is discussed more fully in a later section of this document.

The National Bank should review the geographic locations of inspectors, and determine where the inspectors are needed most. The National Bank should question the wisdom of keeping inspectors in an office where no bank head offices is located. The National Bank might consider creating a more limited regional offices structure, and assign persons to be regional inspection coordinators. The regional coordinators would coordinate the on-site inspection planning process, starting with the banks in the highest risk category and moving through the banks in the lower risk category. The planning process would necessarily improve in accuracy and efficiency as more historical information is obtained and inspectors gain more experience with the inspection process.

The BSD should review the size and composition of on-site inspection teams. Currently, the staff includes persons who are reviewing the bank for compliance with foreign exchange control and cash settlements operations. We certainly would not object to inclusion of these persons on the inspection team; however, their role in the inspection process needs to be directed by the inspector-in-charge. If their work is not specifically directed by the inspector-in-charge, the size of the inspection team performing work directly related to risk-based supervision should not be affected by their inclusion.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Develop policy statement for branch inspections.			
2. Analyze the feasibility of all bank supervision office locations, particularly questioning the need for inspectors in regions where no bank head offices are located.			
3. Develop a more centralized inspection planning process, including appointment of regional coordinators.			
4. Develop a program to provide an incentive for qualified persons from regions to inspection of complex banks.			
5. Develop a long-term program to increase the size of the banking supervision staff of the Kyiv Regional Office and Head Office of the National Bank.			

3. Update Risk-Assessment System and the Inspection Manual

The BSD should compile feedback from the risk assessment seminars and update the risk assessment system. Inspectors, in virtually every seminar location, have expressed their desire for more concrete, numerical targets to judge the quantity of risk and more detail in terms of planning and expectations for reviewing the quality of risk management. The risk assessment system will only become truly effective after several years of experience in its usage and application on bank inspections in evaluation bank risk management systems and following employee accreditation through a systematic career development program.

Numerical targets should not become a permanent addition to the risk assessment system. However, we acknowledge that banking supervision personnel need additional guidance and more formal benchmarks to form their judgments in the early stages of risk-based supervision implementation. Banking supervision personnel should clearly see the weaknesses of numerical targets, which is one of the main reasons for moving away from compliance-based supervision. The following is a miniature case study illustrating the weaknesses of relying too heavily on numerical indicators for each bank.

Case Study on Numerical Indicators

From off-site analysis, we see two banks. Bank A has problem loans totaling 25% of their regulatory capital. Bank B has problem loans totaling 60% of their regulatory capital. Which bank has the most risk? Given this information, we can easily say that Bank B has the most risk. After an on-site inspections and adjustments, we find that Bank A has insufficient and inaccurate problem loan recognition policies and practices, resulting in problem loans totaling 45% of regulatory capital (rather than 25%) while Bank B has an accurate loan review system showing problem loans at 60% of regulatory capital. Further, nearly half of Bank A's problem loans are classified "doubtful" while all of Bank B's problem loans are classified "substandard." After looking at risk management systems, we can safely say that Bank A has a higher level of risk and weaker risk management systems, even though it still has a lower total amount problem loans. Banking supervision cannot rely on off-site reports from Bank A because their risk management systems are weak, causing widespread reporting errors.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Compile participant feedback from risk assessment seminars and develop a document with recommendations for amendments to the risk assessment system.			
2. Develop numerical targets or ranges for quantity of risk in each of the six financial risk categories.			
3. Review, and amend the on-site inspection manual to include a discussion of each of the evaluation factors from the risk assessment system and develop or amend discussions in the inspection manual that will lead to conclusions on each factor.			

It is critically important of obtain feedback from the regional office locations regarding the initial numerical targets for the quantity of risk and amendments to the on-site inspection manual for quality of risk management. While feasible in the first version of the risk assessment system, persons from the head office cannot simply develop these future items in a vacuum and hold others accountable for compliance and consistency. Also, in establishing numeral targets to assist inspectors in judging the quantity of risk, peer information should be considered. However, frequently peer informative is reflective of a higher level of risk in the system as a whole. Therefore, we recommend that the “low” risk category for quantity of risk be set based on developed country ratios, not based on peer group information from Ukraine alone. The moderate- and high-risk categories can be more reflective of the Ukrainian situation, which should improve over time.

4. Amend the Report of Inspection

The standard Report of Inspection (“Report”) should be amended to be consistent with the risk assessment system. The standard Report should include comments for each of the nine risk categories and the inspectors should be required to include a comment regarding each of the general evaluation factors listed in the risk assessment system. The comments should clearly lead the reader to the determination of the bank’s level of risk and its quality of risk management. An executive summary section at the beginning of the Report should include, at a minimum, a comment regarding any risk area considered to be a “high aggregate risk” and an “increasing direction of risk.” The Report should

also include a standard set of financial tables so that numerical information does not clutter the message to the bank's management.

The BSD needs to also consider the issue of the audience of the Report. In other words, to whom is the National Bank writing this Report? This issue is causing certain problems in the regions as off-site analysts criticize the inspectors for not including certain information that the analyst wanted to know from the inspection process, yet the inspector did not consider material for the commercial bank. In international practice, some regulators adopt the attitude that the Report is written from the National Bank to the commercial bank, while other regulators feel the Report is an internal document that is simply shared with, or copied to, the commercial bank. For the most effective message, particularly with regard to risk management, we recommend that the audience of the Report should be the commercial bank. If the BSD head office wishes certain information to be included from each inspection, this might be included as a standard appendix to the Report or as part of a confidential memorandum (or placed within a management information system) that is separate from Report and treated as an internal document.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Approve the revised Report of Inspection to be consistent with the risk assessment system.			
2. Develop instructions for completion of the Report of Inspection.			
3. Include a professional writing course as part of the courses available for bank supervision personnel.			
4. Develop a confidential memorandum or management information system that would capture all necessary information from bank inspections that might not always be included in the Report of Inspection.			

5. Develop a Program to Attract, Train and Retain Bank Supervision Staff

The National Bank needs to develop a program to attract talented persons from the banking industry and from universities to the banking supervision function. Sadly, the role of a civil servant has diminished in value from previous days. Young educated

people are interested in remuneration and possibilities of rapid advancement in an organization by means of merit, not longevity. The National Bank needs to turn its attention to meeting those needs.

Case Studies on Personnel Administration

United States regulators perform a survey periodically on the entry-level salaries of professional staff in the banking industry. The average entry-level salary is used to determine the entry-level salaries of the banking supervisors. Obviously, salaries at mid-sized commercial banks have a much higher realm of possibility than government service; however, a competitive entry-level salary ensures that supervisors are attracting talented persons from universities. Likewise, people are rewarded and promoted on a merit basis to higher levels in the supervisory organization. Rewards are given for teaching courses, for managing difficult inspections of problem banks, for developing new methods of inspections or analysis that helps the organization, etc. When a person is applying for a higher-level position, these factors are considered in addition to the person's longevity in the agency and their general experience.

In Poland, a rather strange phenomenon occurred with development of bank supervision staff. At first, Poland experienced the same problem that Ukraine is experiencing now, with exodus of quality staff members to the commercial banking industry for higher salaries. However, as Poland opened its banking system to more foreign banks, and the foreign banks reduced the staff size of the banks purchased, the number of bankers needed in the industry declined considerably. As a result, the National Bank of Poland's Banking Supervision Department was able to hire many experienced bankers as inspectors. In addition, the National Bank of Poland also realigned the salaries of banking supervision personnel to make careers more attractive to bankers looking for work.

During our training sessions, banking supervisors have confided serious concerns that they are not yet comfortable in judging whether a bank's risk management systems are good or bad, with the possible exception of credit risk. Moving toward a risk-based supervisory approach is a long-term process that should be managed cautiously. The series of risk assessment seminars are setting the basics requirements of the risk assessment system. However, all bank supervision personnel, including management levels, need to have more training on the individual risk areas within risk-based supervision. This training program should be developed and delivered in a systematic manner throughout the department. Training all affected staff on the individual risk areas will consume several years, yet this should not hold back the risk-based supervision program. It is important to start risk-based supervision as soon as possible, and develop a long-term, comprehensive training program to augment the supervisors' expertise and improve their confidence in risk management analysis.

The BSD needs to identify persons as instructors for certain core courses and provide them with the time necessary to prepare to deliver these seminars. This is often a difficult decision, as the best inspectors and analysts are often the best instructors, yet have the least time to spare for this process. However, formal and informal training is not an “extra” item to development of banking supervisors. Training is not simply an item that is obtained externally. Training materials need to be developed and delivered by existing employees, not simply through attending external courses. We certainly recognize a need for certain external courses on complex topics, such as derivative instruments or strategic planning; however, “core” courses should be internally managed to be most effective. Providing people with adequate training is critical to development of risk-based supervision.

The National Bank should consider creating positions of “risk experts” within the BSD Methodology Unit. These persons would have the responsibility of organizing course materials for core courses, updating the on-site inspection manual for specific risk areas, and keeping management and staff informed of current banking trends in their risk areas. These persons might also assist with inspections of the largest, most complex banks in Ukraine. While working in Poland, we recommended that the banking supervision methodology unit be organized along the following six lines of “expertise”: credit risk expert, operational risk expert, market risks expert (foreign exchange risk, interest rate risk, liquidity risk, and price risk), non-financial risk expert (strategic risk, legal risk, and reputation risk), accounting expert, and supervisory processes expert (on-site and off-site processes, report of inspection, off-site analysis reports, management information systems, etc.).

The BSD should also develop an accreditation process for all staff members, which includes basic knowledge in all risk areas. This accreditation process would include certain core courses, on-the-job assignment or seminars that must be successfully completed by every staff member in order to reach a certain level in the organization to be “accredited.” Employees should follow a pre-set development plan for the first several years of employment to be accredited, and then develop their own career development plan based on their expertise from that point forward. This would also be an important marketing tool to the banking industry, showing the competence of supervision staff to judge risk management. An effective accreditation process can also help in the judicial process by demonstrating the level of expertise of banking supervisors in making their judgments.

The BSD should also consider the concept of a normal “career path” for bank supervision employees. Ideally a training program would match the career path. The concept of hiring people directly into the head office of the BSD creates some tensions between regional offices and the head office, as quite often neither party fully understands the other’s role. As an example, if the BSD hires people directly as off-site analysts without any experience as an on-site inspector, the inspector and the analyst will not be able to understand each other’s needs. This results in the situation we have now, whereby analysts do not participate in an inspection, rather they are writing exhaustively detailed and often overly critical letters to inspectors following their receipt of a report of

inspection. Answering these letters detracts from the already scarce time of inspectors and adds minimal value to the supervisory process. The career path should serve to significantly improve the level of communication between on-site, off-site and head office supervision functions, as each function would better understand each other's role in banking supervision in addition to the strengths and limitations of each type of supervision.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Develop and implement a long-term career development plan for banking supervision staff, including a long-term plan to train all staff in risk-based supervision and individual risk categories.			
2. Identify, from within the BSD nation-wide, instructors for core courses and develop all core courses.			
3. Develop a tracking mechanism to identify the core courses and on-the-job experiences that a person needs to reach an "accreditation" level.			
4. Ensure that the time allocation for training and career development is viewed as part of someone's job, not as an "extra item" if time allows. The BSD needs to provide incentives (merit recognition, bonuses, promotions, etc.) for persons to become trainers and for persons to desire the goal of reaching an accreditation level.			

6. Improve the Off-Site Supervision Process

The BSD's off-site analysts play a critical role in the supervisory process for banks. The off-site analysts need to ensure each bank is taking appropriate steps to correct deficiencies noted in the previous inspection and to monitor the future effects of bank's actions in between inspections, including risk that might affect the entire banking system.

To perform the first role above, the analysts need to have in-depth knowledge of the findings from the most recent on-site inspection, including the areas of highest risk and the bank's proposed corrective actions. The expectations for the analysts should be included in the supervisory strategy of each bank. We recommend that the off-site analysts visit the on-site inspections during the initial planning phase and at the end of this inspection as findings are communicated to bank management. The analysts may wish to participate in the individual risk assessment areas of the on-site inspection process for career development, as time permits. This will allow the analysts to have more in-depth knowledge of the bank's conditions and problematic areas. Attending the on-site inspections, even if only briefly, will also allow the analysts to better judge the bank's corrective actions as it submits information between on-site inspections who to contact if questions arise. Currently, it seems the analysts are not involved in the on-site inspection process. The analysts are drafting detailed letters of criticism to the on-site inspectors, only after receiving the final report of inspection in the head office. This seems to be a rather bureaucratic process, is not a productive use of time for the analyst or for the inspectors, and significantly detracts from the overall supervisory process. The supervisory process needs to be more cooperative and interactive to be effective.

To perform the second basic role from above, the analysts should continue to develop new and refine existing early warning systems for banks, and used analysis models for analyzing individual banks and the banking industry. We recommend that the BSD produce a report on an annual basis describing the financial trends and the areas of highest risks in the banking system, including broad recommendations for supervisory actions in the coming year. This will complement the existing quarterly analyses that are already being prepared, but are mostly factual and historical information. This knowledge will be critical for overall supervision planning. Saying this, the BSD should keep in mind that certain misconceptions may exist regarding the use of early warning models. First the models are only as good as the data the model is fed. If banks are submitting inaccurate financial reports, models will not be effective. Second, models rarely, if ever, provide the final answer to any real or potential problem. Models can only show symptoms of problems, not causes. It is important to treat model outputs as a source for more questions, rather than as a final solution. Relative to the issue of systemic risks, senior management of the BSD and the National Bank should look closely at management information systems to ensure that available data is circulated to the proper persons and is sufficient in detail and useful in decision making processes.

Off-site analysts should follow the same accreditation process as on-site inspectors, and attend the same core courses for banking risk. Analysts do need more training in how to analyze bank reports and policies that will be submitted between inspections. We also encourage BSD to consider hire analysts from the existing pool of inspectors, rather than independently hiring analysts from outside the National Bank system. This will encourage more career development and foster a career path for employees, and will break down many of the communication walls that exist between inspectors and analysts.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Approve the off-site analysis summary document.			
2. Develop a requirement for analysts to attend on-site inspections.			
3. Ensure that analysts are also included in the BSD accreditation program and are able to attend core courses in banking risk.			
4. Develop and refine early warning analysis models.			
5. Prepare an internal, annual report on the condition of the banking industry, banking risks and banking trends, and recommendations for supervisory actions.			

7. Enhance Banking Legislation for Risk Management Principles

Licensing requirements in Ukraine already contain certain provisions related to risk-management systems. In order to improve existing legislation and implement the recommendations of the World Bank/IMF Financial Sector Adjustment Team, a significant number of changes to the Banking Law will be necessary. Some of these items may also necessitate corresponding changes to other legislation. The changes include the following¹.

Risk management systems and internal controls. There should be affirmative requirements for banks to have adequate *systems* of risk management and internal controls, both as a condition of registration or licensing and on an ongoing basis. The current version of the Banking Law requires a risk management “unit” and internal audit “service” but does not require risk management or internal control *systems* that, in the judgment of the NBU, are adequate and appropriate for the given bank’s activities and profile. We have received a draft from the NBU Legal Department which would require “availability of internal policies to regulate the carrying out of banking operations according to the requirements of [the Banking] law, rules and regulations of the NBU, and the bank’s statute” as a condition for receiving a banking license. This is a good start, but more is necessary.

¹ Communicated in a memo dated May 28, 2003.

Enforcement measures. Article 73 should clarify that the NBU has the authority to require improvement in the risk management and/or internal control systems in a bank when, in the judgment of the NBU, these items are inadequate. Also, the NBU should be able to require more capital depending on level of risk in bank's activities, as determined by the NBU based on its analysis and evaluation of the bank's situation. We have received a proposed amendment drafted by the Law Department, which would eliminate the performance of "risky operations that would endanger depositors' interests" as a basis for enforcement action. In our view, this would be a mistake. The NBU should have the legal authority to require correction of *any* situation that, in its judgment, could be detrimental to the stability of a bank or endanger the interests of its depositors.

Strengthening the responsibilities of Supervisory Councils. Additional emphasis should be placed on making the supervisory council responsible for approving/overseeing the implementation of the bank's strategy, risk management, internal controls, etc., as well as ensuring the bank's compliance with all applicable legal requirements and fulfilling their fiduciary duties.

The "Revision Commission" concept should be eliminated. Enterprises (including banks) in most western countries do not use a "revision commission," but rather an audit committee, which is a committee of the supervisory council, and the function of which is to assist the supervisory council with the more technical financial matters and oversight of the internal controls and internal audit function. The audit committee is one of the most important committees in a bank.

Strengthening licensing/registration requirements. The law should require information on business reputation of all proposed holders of essential participation. Article 18 says the NBU can refuse registration if a proposed essential participant does not have an impeccable business reputation, but Article 17 does not require submission of such information in the first place. Also, the Article 17 requirements should be tied to Article 34, which requires all essential participants to have an impeccable business reputation. Information on professional skills and experience of all proposed supervisory council members should also have to be submitted at the registration stage.

Transparency of ownership/control. Article 34 does not require approval for "control," but 50% ownership. Addition of a "beneficial owner" concept may be helpful, but the critical issue is the NBU should be able to approve any *de facto* "control" situation in a bank, regardless of the amount of share ownership (if any). The NBU should also have the legal ability to assess the complete ownership structure of proposed bank or banking group, both at the registration/licensing stage and as a result of change in control or significant ownership – and reject applications if proposed or resulting ownership structure is not sufficiently transparent.

Consolidated supervision. The NBU needs the legal ability to review structure, corporate governance provisions, internal controls and risk management, and suitability of management in any "group" of companies that includes a bank. This is an extremely important concept: failure to practice effective consolidated supervision (Basel Core

Principle 20) results in non-compliance with many of the other Core Principles. There is a new European Union Directive (December 2002) on Supplemental Supervision of Financial Conglomerates. While some of this directive is probably more complex and detailed than is necessary for Ukraine presently, much of it is highly relevant and should be implemented as soon as possible. This is the case, in particular, with requirements for group-wide risk management systems, internal controls, and appropriate skills and business reputation for managers of companies that control banks.

Treasury stock purchases (banks buying back their own shares). The NBU should have the authority to approve *any* purchase by a bank of its own shares, and the bank should have to demonstrate to the NBU's satisfaction that such a transaction would be for a legitimate business purpose which is beneficial to the bank (not necessarily to the shareholders who wish to sell their shares back to the bank).

Transactions with related parties. The provisions in the Law need to be strengthened, in accordance with the FSAP Team's recommendations.

External audits. The Banking Law does not require auditors' reports to be furnished to the NBU, or that auditors inform NBU about violations or conditions discovered during audits that could detrimentally affect banks. We have received a draft provision from the NBU Law Department, which would require the submission of audit reports, but does not require the auditors to provide other information as described above. There should also be a requirement for bank management to implement recommendations of internal/external auditors.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. See above for a listing of items to include in the Banking Law.			

8. Review and Enhance Management Information Systems

The BSD and National Bank senior management groups need to review all management information systems, such as the "Bank Dossier", emanating from banking supervisory personnel. Senior management should consider what is "critical" information for periodic reports, and what is "extra" information to be used as support. Management information should be both concise and descriptive. The general discussion of management information systems should also be covered in the strategic plan.

The BSD should develop a series of new management information charts to show the aggregate risk assessments of banks in Ukraine. We suggest the following information to be displayed: the percentage of banking assets having high, moderate and low risk in each risk category; the percentage of banks having high, moderate and low risk in each risk category; the percentage of banking assets with increasing risk in each risk category;

and the percentage of banks with increasing risk in each risk category. These charts should be updated quarterly or semi-annually – more frequent updates would be not useful as information would not be changing significantly on a monthly basis. The BSD may have other useful suggestions to illustrate the overall risk and risk trend in the banking system. Additionally, the NBU senior management team should also provide input to the information they would like to receive on a regular basis.

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Review management information systems for sufficiency and conciseness.			
2. Develop new management information systems to illustrate risk assessments and trends in the banking sector.			

As a note, the new management information systems need to incorporate relevant information from other National Bank departments, including violations of law or regulation, so that this information can be incorporated into the overall risk assessment.

9. Develop a Quality Assurance Program

An effective quality assurance program is necessary for implementation of risk-based supervision due to the subjectivity of decisions to be taken. However, it is important to take a proper attitude toward a quality assurance program. Quality assurance is not intended to be a “re-inspection” of a bank to show what someone else would have done given the same circumstances. Rather, quality assurance should be process-oriented, looking at the inspection and analysis procedures used and the documented support for inspection and analysis findings. The persons performing quality assurance should not adopt a punitive attitude toward inspectors and analysts, yet should be simply be ensuring that all supervisory decisions and information are based on and supported by facts. Where supervisory processes need improvement, the quality assurance function should make recommendations to BSD management on changes to improve the process.

The BSD should develop a team of persons to form quality assurance reviews. The banks selected for review should be selected randomly, and preferably be geographically dispersed. The primary areas of review could be the following:

Continuous Supervision of the Bank and the Bank’s Risk Profile: Were the CAMELS and RAS consistent with examination findings? Were any interim changes to CAMELS and RAS properly documented? Were quarterly off-site analyses conducted to specifically address any changed in CAMELS, RAS and bank activities? Do quarterly

analyses include bank management's responses to recommendations in report of inspection and compliance with any applicable enforcement actions?

Full-Scope Safety and Soundness Supervision Activities: Did the full-scope review address each of the nine banking risks and assess the risk to earnings and capital in each of the risk areas? Did the on-site examination team support their conclusions of the aggregate risk profile for each risk area and the direction of risk per the risk assessment system? Did the examining team address the accuracy of the bank's internal loan review system and the bank's ability to determine an adequate level of loan loss reserves?

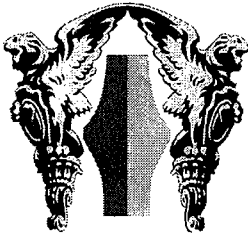
Supervisory Strategies: Do supervisory strategies reflect all significant supervisory concerns identified at the most recent inspection? Were strategies amended when there are changes to the risk profile of the bank? Did strategies result in correction of significant deficiencies at the bank? Did subsequent supervisory activities reflect the scope and resources indicated in the strategy?

Communications: Did the formal communications to the bank address major risks and supervisory concerns? Were interim changes to CAMELS and RAS are communicated to the appropriate persons in the Banking Supervision Department of the NBU?

Examination policies and procedures: Were the minimum inspection procedures are used properly? Were inspection procedures expanded, when appropriate? Was the resource usage is consistent with findings and risk profiles.

Documentation: Do examination working papers properly support findings in the Report of Examination? Do analyst's working papers properly support communication with the bank and quarterly monitoring and analysis of the bank?

Task	Time Frame for Completion of Task	Resource Allocation for Task	Person(s) Responsible for Task
1. Develop and approve a quality assurance program.			
2. Identify qualified persons to perform quality assurance reviews – might be handled as a temporary assignment to get more participation.			
3. Develop a schedule of quality assurance reviews and implement this schedule.			
4. Prepare an annual summary of quality assurance reviews with recommendations for BSD and NBU senior management.			



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APPENDIX F

SYSTEM-WIDE RISK MATRICES

Categories of Banking Risk and Common Methods of Risk Measurement

Category of Banking Risk	Common Methods of Measurement	System-Wide Aggregate Risk (High, Moderate or Low)	System-Wide Direction of Risk (Increasing, Stable, Decreasing)
Credit	1. Balance Sheet Analysis – Types of Lending 2. Concentrations of Credit 3. Internal Loan Ratings / NBU Ratings 4. Credit Scoring Systems 5. Past Due Listings 6. Probabilities of Default and Losses Given Default (per Basle II)	High	Increasing
Liquidity	1. Balance Sheet Analysis – Types of Liquid Assets 2. Maturity GAP (aggregate) 3. Maturity GAP (for each foreign currency) 4. Cash Flow Analysis 5. Simulation / Forecasting 6. Market Terms for Inter-Bank Borrowing 7. Deposit Taking Terms Compared with Competition	Moderate	Stable to Increasing
Interest Rate	1. Repricing GAP 2. Simulation / Forecasting 3. Duration 4. VaR	Low	Increasing
Foreign Exchange	1. Open Position 2. Simulation / Forecasting 3. VaR	Moderate	Stable
Market (Price)	1. Size of Trading Portfolio 2. Historical Volatility of Trading Portfolio / VaR 3. Liquidity of Trading Portfolio	Low	Stable to Decreasing

Operational (Transaction)	1. Audit Review Ratings 2. External Audit Findings for Internal Controls 3. Gross Income by Major Types of Business Activity (per Basle II) 4. Review of New Products and Services 5. Annual Budget and Follow-Up for Adherence 6. Employee Turnover 7. Computer System Downtime	Moderate	Increasing
Legal (Compliance)	1. Number / Amount of Lawsuits Pending 2. Number of Customer Complaints 3. Loss Record on Lawsuits 4. New Products and Services 5. Compliance Reviews 6. Results of Government Body Investigations (NBU, MoF, Tax Police)	Moderate	Increasing
Strategic	1. SWOT Analysis 2. External Reviews 3. Compliance with Goals / Plans / Budgets	Moderate to High	Increasing
Reputation	1. Market Surveys / Questionnaires 2. Number of Customer Complaints 3. CAMELS Rating	Moderate	Increasing

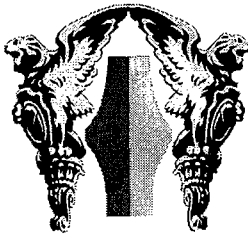
Common Banking Products and the Associated Risks

Banking Product	Credit Risk	Liquidity Risk	Interest Rate Risk	Foreign Exchange Risk	Market (Price) Risk	Operational Risk	Legal (Compliance) Risk	Strategic Risk	Reputation Risk
Inter-bank Accounts	Moderate	Low	Low	Low to Moderate	Low	Moderate	Low	Low	Moderate
Bonds – Ukrainian Government	Moderate	Moderate	Low to Moderate	Low	Moderate	Moderate	Low	Moderate	Low
Bonds – Corporate	High	Moderate to High	Low	Low to Moderate	High	Moderate	Moderate	Low	Low
Equities – Exchange Traded	High	High	Low	Low	Moderate	Moderate	Low	Low	Low
Equities – Over the Counter	High	High	Low	Low	High	Moderate	Moderate	Moderate	Moderate
General Commercial Lending	High	Moderate	Low	Moderate	Low	Moderate	Moderate	Low	Moderate
Commercial Real Estate Lending	High	Moderate	Moderate	Moderate	Low	Moderate	Moderate	Moderate	Moderate
Commercial Real Estate Construction	High+	Moderate	Low	Moderate	Low	High	Moderate	Moderate	Moderate

Banking Product	Credit Risk	Liquidity Risk	Interest Rate Risk	Foreign Exchange Risk	Market (Price) Risk	Operational Risk	Legal (Compliance) Risk	Strategic Risk	Reputation Risk
Residential Mortgage Lending	Moderate	High	Moderate to High	Low to Moderate	Low	Moderate	High	Moderate	Moderate
Consumer Lending – Term	Moderate	Moderate	Low to Moderate	Low to Moderate	Low	Moderate	Moderate	Moderate	Moderate
Consumer Lending – Revolving	High	Moderate	Low	Low	Low	Moderate	High	Moderate	Moderate
Leasing	Low to Moderate	Moderate	Low to Moderate	Low to Moderate	Low	Low to Moderate	Moderate	Moderate	Moderate
Fixed Assets	Moderate (valuation questionable)	High	Low	Low	High	Low	Moderate	Moderate	Moderate

Banking Product	Credit Risk	Liquidity Risk	Interest Rate Risk	Foreign Exchange Risk	Market (Price) Risk	Operational Risk	Legal (Compliance) Risk	Strategic Risk	Reputation Risk
Inter-bank Accounts	N/A	Moderate	Low	Low to Moderate	N/A	Moderate	Low	Low	Moderate
Demand Deposits	N/A	Low to Moderate	Low	Low	N/A	Moderate	Low	Low	Low
Time Deposits	N/A	Low	Moderate	Low to Moderate	N/A	Moderate	Low	Low	Low
Senior Debt	N/A	Low, until maturity	Moderate	Moderate	N/A	Low	Moderate	Moderate	Moderate
Subordinated Debt	N/A	Low, until maturity	Moderate	Moderate	N/A	Low	Moderate	Moderate to High	Moderate to High
Common Stock	N/A	Low	N/A	Low to Moderate	N/A	Low	Low	Moderate to High	Moderate to High
Preferred Stock	N/A	Low	N/A	Low to Moderate	N/A	Low	Moderate	Moderate to High	Moderate to High

Banking Product	Credit Risk	Liquidity Risk	Interest Rate Risk	Foreign Exchange Risk	Market (Price) Risk	Operational Risk	Legal (Compliance) Risk	Strategic Risk	Reputation Risk
Derivative Products	Moderate	Moderate to High	Moderate to High	Moderate to High	Moderate to High	Moderate to High	Moderate to High	Moderate	Moderate
Trade-Related Letters of Credit	Low to Moderate	Moderate	Low	Moderate	Low	High	High	Low to Moderate	Moderate
Lines of Credit	Moderate	Moderate	Low	Moderate	Low	Moderate	Moderate	Low	Moderate



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APPENDIX G

GENDER SURVEY

JUNE 2005

The Scope and Purpose of Survey

The purpose of this survey was to determine a gender composition of the banking supervision function of the NBU and to make conclusions about presence or absence of gender discrimination. This survey is not designed to be an evaluation of the USAID “Banking Supervision Development Project.” This survey is a reflection of findings. Our project did not have any objectives, goals or benchmarks on the issue of gender.

General Conclusions

Our advisors collected information on the number of men and women in the banking supervision function of the NBU. We analyzed the banking supervision function of the Central Office of the NBU and respective functions in the Regional Offices of the NBU located in oblast centers of Ukraine, including the Central Directorate of the NBU in the autonomous Republic of Crimea located in the city of Simferopol.

Complete absence or insignificant presence of women in senior management of government agencies or bodies is typical for Ukraine. The NBU is not an exception. In spite of the fact that the dominating majority of the NBU personnel are female, their representation decreases significantly as the level of positions increases. A similar situation is observed at the regional offices of the NBU as well. Although a majority Regional Office Directors of the NBU are men, 50% of their deputies are women. When we view banking supervision departments at NBU Regional Offices, the number of women who hold Head or Deputy Head positions is increasing. Overall, women head 68% of banking supervision functions in regions of Ukraine. It is interesting to note that woman managed the banking supervision departments in regions where a significant number of banks-legal entities are registered (i.e. such cities and oblasts as Kyiv, Dnipropetrovsk, Odessa, Kharkiv, Lviv, Zaporizhzhya, Luhansk, The autonomous Republic of the Crimea).

Taking into consideration the abovementioned data, the general conclusion of this survey is the absence of specific gender discrimination at the NBU and in its banking supervision function. Over the last three years the gender composition of banking supervision function has not changed significantly, in spite of numerous organizational changes and changes in the number of personnel.

Background

Before we begin the discussion of the gender composition of the BSD of the NBU, we need to define the term ‘gender’. Under the definition of the Organization of Economic Cooperation and Development, “gender” refers to “the economic, social, political and cultural attributes with being male or female” (DAC Guidelines for Gender Equality and Women’s Empowerment in Development Cooperation. OECD: Paris, 1998). In other words, the term “gender” means sex as social conception and phenomenon, as well as a combination of social relations and links formed beyond biological sex.

The legal aspect of the gender issue in Ukraine, and the legal status of women in particular, are regulated in the Constitution of Ukraine (Article 24). The issue of women rights are also addressed in other laws and regulations, such as Labor Code, the Family Code, the Criminal Code, the Civil Code, The Laws of Ukraine “On Employment”, “On Pension”, “On Labor Protection”, etc. the legislation regulating rights of women is based on the provision of the Constitution. There is no Law in Ukraine that would give priority to men, thus limiting rights of women¹.

Ukraine has officially acceded to major international documents that deal with the issues of improving the status of women and increasing their role in the society, creating conditions for equal participation of women and men in decision making processes at all levels of power. In 1980 Ukraine ratified the United Nations Convention on Liquidation of all forms of discriminations of women, thus recognizing the principle of gender equality as fundamental. This international document has been and will remain the most important basic document that regulate activities of all countries in the area of development and implementation of the policy on equal opportunities and rights for men and women.

Of course, the legal equality between sexes does not mean their actual equality. Under Ukrainian laws and regulations women have broad opportunities for self-realization, but in fact there are no mechanisms that would ensure equality of men and women in almost any sphere. The process of legal regulation and actual realization of social and economic relations is always influenced by physiological difference between men and women, their traditional social roles, as well as by stereotypes formed in the society in the course of centuries.

Similarly to the most modern societies, Ukraine is characterized by the domination of patriarchal relationships formed historically. Even through emancipation of women in Ukraine is undoubtedly going on, it is yet early to declare the existence of gender equality.

According to the data of the National Census, as of January 2003 the population of Ukraine totaled 48 million inhabitants, 25.7 million of them (or 54%) are women. Among the

¹ It is easy to argue, however, on the very fact of the separation of “rights of women” versus “human rights” which can be treated as discrimination, since it implies the opposition “human being-woman”. It would be far beyond the nature and purpose of this survey. Therefore, we will conditionally accept the factual existence of legal equality of women.

population of Ukraine with higher education (with university degrees), 60% are women. Among current students of higher educational institutions in Ukraine, 54.7% are women. It is worth mentioning that among students of universities of economics and trade, i.e. those that educate many of the future bankers and employees of the NBU in particular, 67% are women.

One of the main indicators of the level of democratization in society is participation of both sexes in state or state-related governing bodies, one of them being the NBU. According to the data of the State Committee on Statistics as of January 1, 2004, the number of civil servants in Ukraine equals 240 thousand, including employees of the NBU. Of the 240 thousand total, 180 thousand are women, while only 60 thousand are men. As can be seen, 75% of the state work force is women. A similar situation is observed in bodies of local government, where among 85 thousand employees, approximately 75% are women.

As can be seen, among the overall number of civil servants, managers and specialists, women constitute a dominating majority, but at the same time their representation decreases abruptly in accordance with increase of the level of positions. For example, in the sixth or lowest category of positions, the percentage of women who hold positions of management is 68% while in the first or highest category only 7% of the population is shown. A similar situation is observed in the central bodies of executive branch, where at the highest levels of management there are only 8% women. The Verhovna Rada 2002 Convocation only has 5% women out of 450 Members.

Gender composition of Top Management of the NBU Central Office and at NBU Regional Offices

We consider nine persons as “senior” management of the NBU, none of whom are women. Among sixteen (16) members of the Board of the NBU three (3) are women, including the Chief Accountant (Director of Accounting Department), Director of Monetary Policy Department and Director of Financial Management Department.

Among twenty-five (25) Directors of Regional Offices of the NBU (including the Central Directorate of the National Bank of Ukraine in the Autonomous Republic of Crimea), there are four (4) women. These women are Directors of the Regional Offices of the National Bank of Ukraine in the oblasts of Kirovograd, Lviv, Sumy and Kherson. It is interesting to note that among forty-five (45) Deputy Directors of Regional Offices of the NBU there are twenty-one (21) or 47%.

Among four (4) Directors of Departments that belong to banking supervision function, one (1) is a woman. Among twenty-five (25) heads of banking supervision department at the Regional Offices of the NBU, there are seventeen (17) women. Among the gender composition of deputy heads of banking supervision department at the Regional Offices of the NBU, we see eighteen (18) women and seven (7) men.

Gender composition of banking supervision function of the National Bank of Ukraine

Our advisors collected information on the number of men and women in the banking supervision function of the NBU. We analyzed the banking supervision function of the Central Office of the NBU and respective functions in the Regional Offices of the NBU located in oblast centers of Ukraine, including the Central Directorate of the National Bank of Ukraine in the Autonomous Republic of Crimea located in the city of Simferopol.

For the purposes of this analysis, we grouped Regional Offices of the NBU by geographical regions: North, South, East, and West. The group **“North”** includes the NBU Regional Offices in Kiev, Zhytomyr, Vinnytsia, Chernihiv, Cherkassy, Khmelnytsky and Poltava. The group **“South”** includes the NBU Regional Offices in Odessa, Kherson, Mykolayiv, Kirovograd and the Autonomous Republic of the Crimea. The group **“East”** consists of Donetsk, Luhansk, Dnipropetrovsk, Zaporizhzhya, Kharkiv and Sumy. The group **“West”** covers Lviv, Ivano-Frankivsk, Ternopil, Rivne, Lutsk, Chernivtsi and Uzhhorod.

All positions in the NBU banking supervision function can be divided into five groups:

- **top management** (*Deputy Governor in charge of Banking Supervision, Directors of Departments of banking supervision functions of the National Bank of Ukraine*);
- **middle management** (*Deputy Directors of Departments of banking supervision functions of the National Bank of Ukraine, Heads of Divisions, Heads of Banking Supervision Departments in the Regional Offices of the NBU*);
- **line management** (*Deputy Heads of Divisions, Deputy Heads of Banking Supervision Department of the Regional Offices, Heads of Deputy Heads of units of banking supervision function, Sector Managers*);
- **specialists** (*Senior and Leading Economists*);
- **specialists of lower categories and other staff** (*Economists of I, II categories, Economists, Specialists, etc*).

Since the top management group of banking supervision functions, according to this classification, only includes only five persons, data on the gender composition of this top management group was discussed separately and is presented above. Table 1, provided at the end of this document, represents a gender composition of the banking supervision function of the NBU, except the top management group.

As we can see, the overall number of banking supervision personnel at the NBU is 911 (together with 4 Directors of Department of Banking Supervision function of the NBU)². This is almost 40% more than in 2002 when our project conducted a similar research. This significant increase in the number of personnel can be explained by the fact that in 2003 a

² The overall number of personnel in banking supervision function of the NBU, as was estimated by the project, differs from the NBU official list of staff members, since we did not take into account vacancies and the factor of relatively high turnover of staff observed at the NBU. The statistical error constitutes 2-2.5% and does not impact the overall gender composition of banking supervision personnel at the National Bank of Ukraine.

foreign exchange control function was made part of banking supervision area³. It is also necessary to note that in the course of 2002 – 2005 the NBU, and its banking supervision function in particular, went through significant organizational and structural changes, including significant changes in top management groups at all levels. In addition, at the beginning of 2005 the General Department of Banking Supervision was dissolved. As a result, the banking supervision function now consists of four departments (mentioned above), each of which falls under one of the Deputy Governors (Mr. Krotiuk). Changes in personnel and in organizational structure of banking supervision function are still underway and are not reflected in this survey, which is based on the data of 2004.

Among the 911 employees of banking supervision function there are 646 women and 265 men, or 71% and 29% respectively. In 2002 this ratio was 73% and 27% respectively. Therefore, in spite of significant increase in the number of personnel of banking supervision function (by almost 40%), its gender composition has not changed significantly. In general, such gender composition is typical for government institutions and agencies that on average employ 75% women. If we analyze gender composition of top management of banking supervision function, we can see that among five people who belong to this group there is only one woman. In 2002, when a similar survey was conducted, the resulting percentages were 12% women and 88% men. In reality, the number of women is still one person. The difference in percentages is explained by higher number of management positions in 2002 (eight) compared with 2005 (five).

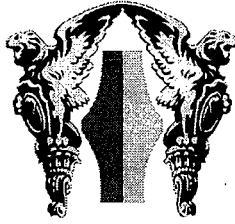
The number of women in middle and line management, as well as on the positions of specialists (i.e., in the first, second and third categories of Table 1) is within the traditional range of 70-77%, which is typical for civil service in Ukraine. However, in the lowest category of positions there are 62% women and 38% men. This can be explained by the fact that young men and women university graduates who start their careers at the NBU from these positions, work in the system of the NBU for several years, obtain valuable experience, and then move to the commercial banking sector, which offers more attractive compensation and better career opportunities. From informal discussion and observation, it seems that those who stay longer in the NBU system are mostly women, who are interested in more stable and predictable employment, as opposed to increased compensation and more risk. In addition, the status of civil servant offers additional advantages, such as better retirement plans and some benefits (kindergarten for children, longer vacations, etc) that are more attractive for women. After several years at lower positions, women who prefer to stay at the NBU do move to higher positions.

Over the most recent years, the NBU has become a more attractive place of employment for a variety of factors not least of which is an improved salary scheme. As a result, we would expect a trend of gender makeup to more closely resemble the private sector, rather than the public sector, in the future.

³ At the beginning of 2005, the foreign exchange control function was again separated from the banking supervision area. Thus, the number of banking supervision staff in 2005 decreased again by approximately 25-30%.

Table № 1

Categories, except for top management group	Middle management (1)				Line management (2)				Specialists (Senior and Leading Economists) (3)				Specialists of lower categories and other staff (4)			
	№№		%		№№		%		№№		%		№№		%	
	W	M	W	M	W	M	W	M	W	M	W	M	W	M	W	M
Central Office (198)	13	5	72	28	23	12	66	34	85	33	72	28	18	9	73	27
East (222)	4	2	67	33	27	9	75	25	90	22	80	20	39	29	43	57
West (135)	4	3	57	43	21	5	81	19	55	32	63	37	9	6	60	40
North (219)	5	2	71	29	27	6	82	18	84	29	74	26	44	22	67	33
South (133)	4	1	80	20	19	2	84	16	49	15	77	23	25	18	58	42
Total (907)	30	13	70	30	117	34	77	23	363	131	73	27	135	84	62	38



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APPENDIX H

**MANAGEMENT RATING SURVEY
FOR TIER I AND TIER II BANKS IN UKRAINE**

JUNE 2005

1. General Information

Background

This Task Order calls for two surveys to be completed and submitted to USAID – one before the end of the first year of contract (June 30, 2003), and second – before the end of the entire contract (June 30, 2005). The first survey was completed in June 2003 and submitted to USAID. This document represents the second requested survey.

The purpose of this survey is to assess an average “CAMELS” component rating for management quality (the “M” Rating) for a sample of Ukrainian banks. The Task Order specifies that the sample shall include banks incorporated in Ukraine that are classified by the NBU as “Tier I” and “Tier II” banks. As of January 1, 2005 there were 24 banks, representing a 9% increase compared to January 1, 2003 (22 banks).

Disclaimer

The survey is based on the official data requested and obtained from the NBU, which is the only rightful owner of such ratings.

The Bank Supervision Development Project has not participated in any onsite examination of the banks surveyed and had no control over the ratings being assigned to individual banks. Assignment of ratings is the responsibility of the NBU’s General Department of Bank Supervision. Our responsibility was to retrieve the data and assess the averages.

2. Survey Results

Banks Surveyed

Currently the NBU places banks into peer groups based upon net total assets. Respectively, the survey covered twenty-four banks, each with total assets equalling or exceeding UAH 1,200 million (USD 226.4 million at official exchange rate as of the date) as of January 1, 2005. For the purpose of the previous survey the respective threshold was UAH 500 million (USD 94.2 million at official exchange rate as of January 1, 2003).

It is important to notice that despite the fact that this survey covered almost the same banks – two banks joined the population and one bank exited – the total asset size of most banks almost tripled in two years. As of January 1, 2005 these banks held 71.2% of net total assets and 58.2% of total regulatory capital of the Ukrainian banking system.

Due to confidential nature of information bank names were replaced by a code. Table 1 below represents the raw data used in the Survey.

Table 1. Tier I and Tier II Banks M Ratings

Bank Number	M Rating	Date Last Examined	Bank Number	M Rating	Date Last Examined
1	2	May-03	13	2	Oct-03
2	3	Jan-04	14	3	Jan-04
3	3	Apr-03	15	2	Aug-04
4	3	Jan-03	16	3	Oct-04
5	2	Oct-03	17	4	May-04
6	2	Nov-03	18	2	Sep-03
7	2	May-04	19	3	Jun-04
8	3	Jul-04	20	3	Mar-04
9	3	Aug-04	21	2	Mar-03
10	2	Apr-04	22	3	Jul-03
11	3	Dec-03	23	2	Oct-02
12	3	Apr-03	24	3	Sep-04

As can be seen from the table, the dates of last onsite examinations, when the “M” Rating was assessed, range from as early as October 2002 to as late as October 2004. For some banks, an on-site examination was in process as we completed these survey results. Figure 1 below shows the distribution of time periods when management quality ratings were given to banks. Compared to the data obtained for the previous “M” Ratings review, we noted that most of the banks in this survey has had at least two CAMELS assessments during the tenure of our project.

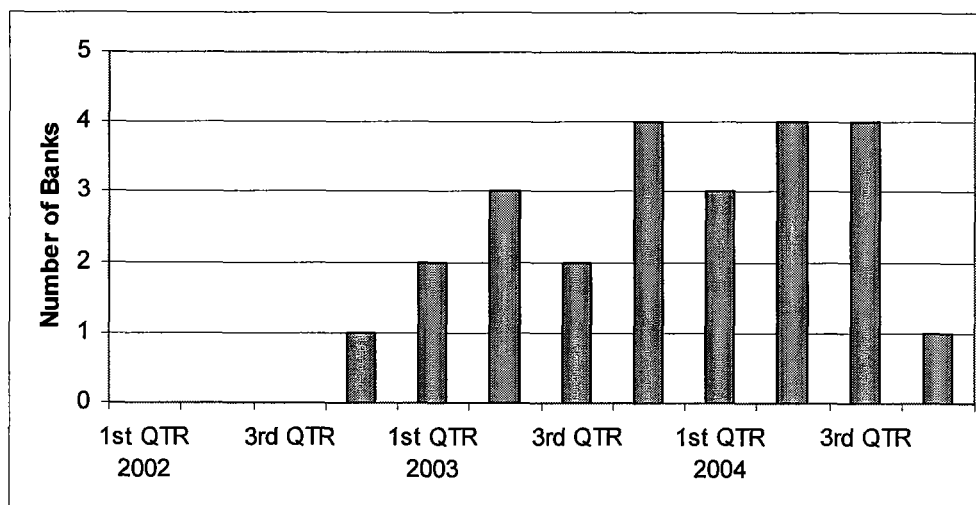


Figure 1. Time Distribution of Last Exam Dates

Our assumption made in the previous survey that updated rating will be based on the new risk assessment system, and therefore better reflect NBU's reaction to how bank managers can deal with existing and potential challenges, appears to have been optimistic. In fact, NBU adopted the Risk Assessment System only in March 2004, and most of the years 2004 and 2005 were devoted to training. During this time the Risk Assessment System was mostly optional and was not used to drive Management Quality conclusions in all banks being examined, also in some banks it was the case.

M Rating Averages

For the purposes of this survey, the mode, median and mean were calculated to represent average rating of management quality. Please be advised that in a set of values, the mode is the most frequently occurring value; the median is the value that belongs to the middle member of a ranged series; and the mean is the average value. No single measure of central tendency provides a complete picture of the data. The distribution of banks to rating categories is shown on Chart 1.

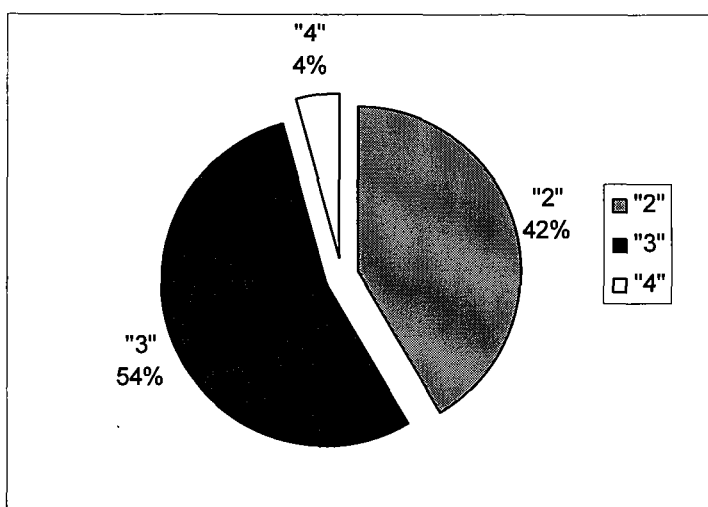


Chart 1. Distribution of M Ratings Across Rating Categories

The Survey returned the following averages of “M” Rating:

Mode: “3” (“2” as of last survey)
Median: “3” (“2” as of last survey)
Mean (simple average): 2.6 (2.4 as of last survey)

Please note that also the semantic of CAMELS ratings is numerical, no fractions are possible. Therefore simple average of 2.6 can only be used for illustrative purposes since no bank can obtain a rating that has any digit after the decimal point. Charts 2 and 3 below are provided for comparison with previous survey. They are intended to illustrate both the absolute and relative changes in the “M” Ratings that occurred over the two years period.

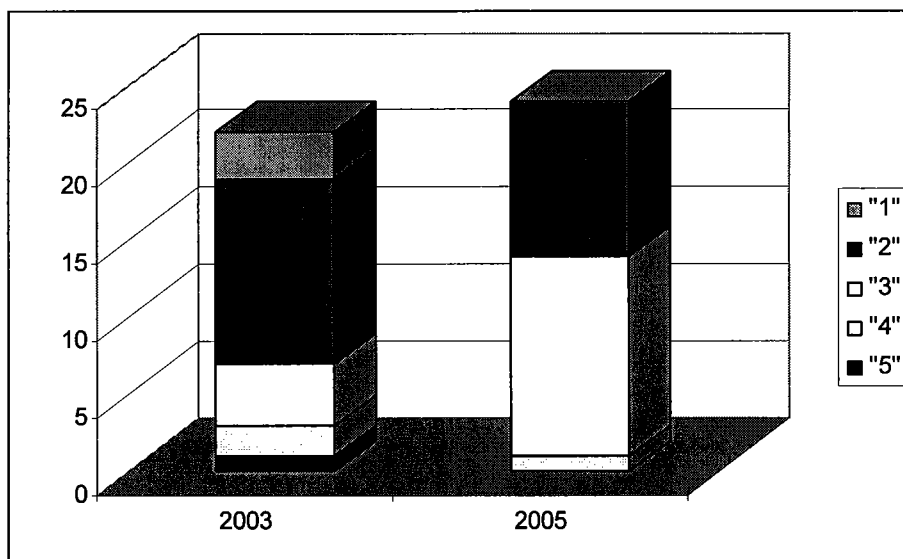


Chart 2. Changes in number of banks and “M” Ratings in 2003 – 2005

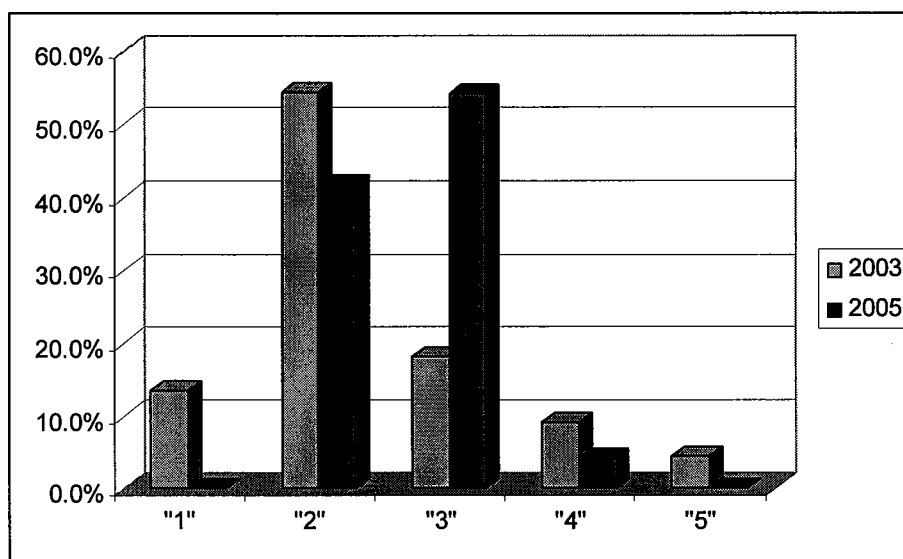


Chart 3. Changes in weights of “M” Ratings in 2003 – 2005

3. Conclusions

The following important conclusions can be drawn from the data shown above.

1. *In general, M ratings have shown a worsening trend in the banking sector.*

This conclusion deserves careful and cautious interpretation. A deterioration in the assessment of a bank's management rating team could be the result of many causes: 1) a new management team has taken charge of a bank and is not as strong as the previous management team or simply does not yet have a proven track record with the bank in question; 2) the risk profile of a bank has changed and the bank's management team is not fully capable of dealing with these changes; or 3) a better, more rigorous and standardized approach to assessing management as part of an on-site examination.

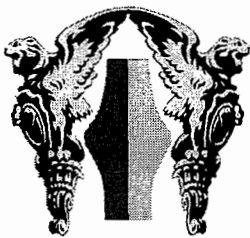
We believe a combination of the second and third items from this list are relevant to Ukraine. Banks, and particularly their loan portfolios, have grown at an extremely rapid rate over the past several years. It is difficult for the management of any organization to maintain control of their culture and controls in this rapid growth environment. Also, management teams in Ukrainian banks do not have a proven record of dealing with economic downturns. The factors in the banking industry are coupled with the NBU's progress in onsite examinations through years of training and experience shows an improvement in overall management assessment skills. It is especially important to notice that NBU managed to exercise a more conservative approach to bank ratings over a period of rapid and continued growth – over two years total assets of the banks in survey almost tripled, although the number of banks was almost the same. Without conclusive evidence of any deterioration in the quality of management during a period of rapid growth, we believe the appearance of deterioration is a result of examiner's improved ability to exercise judgement and analyse management systems and processes.

2. *M ratings for Tier 1 and Tier 2 banks became more concentrated.*

During previous review we have found that the entire spectrum of available ratings – from “1” to “5” – was used to assess management performance in the largest banks. The numbers for 2005 review show that such spectrum was narrowed as all banks reviewed had a “2”, “3” or “4” rating for management. We believe examiners have realized the high standards needed to justify a “1” rating, and an overall improvement in the economy has eliminated the near-term failures or “5” ratings.

3. *The later than expected introduction of the Risk Assessment System means that a true correlation of its influence on management ratings is not possible.*

The NBU introduced the Risk Assessment System in March 2004, with optional use through the end of 2004. The normal duration of an on-site examination of a large bank is 18-20 weeks, plus two weeks for preparation of conclusions and wrap-up. As of the survey date, we have no evidence of an “M” rating that was assessed after *mandatory* use of the Risk Assessment System. However, we need to state the optional use of the Risk Assessment System was an important reference for on-site examinations during eight months in 2004. Nine banks examined after March 2004 showed that the “M” ratings mode was “3”, median was also “3” and simple average was 2.7. As such, the results for such sub-population are materially consistent with the results for the entire population, and the above results can be reasonably extrapolated over the entire banking industry. We firmly expect that continued use of the Risk Assessment System will only improve supervisors' ability to assess bank management in proper manner, as is already being evidenced.



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APPENDIX I

**KEY FINANCIAL DATA AND PERSONNEL
1994-2005**

**Key Data From USAID Bank Supervision Projects
National Bank of Ukraine**

Contract No.	PCE-I-00-99-00006-00 Banking Supervision Development Project (SEGIR EP)	121-C-00-98-00628-00 Ukraine Infrastructure Development: Bank Supervision Contract (CPFF)	EPE-I-00-95-00048-00 Financial Infrastructure Development: Bank Supervision (T&M)	CCN-009-C-00-3147-00 NIS Monetary Restructuring (T&M)
Task Order No.	827		13	15
Dates	July 2, 2002 – September 2, 2005	December 1, 1998 – June 30, 2002	April 1, 1997 - November 30, 1998	August 1, 1994 – March 31, 1997
Contract Value	\$2,262,339	\$5,408,949.00	\$2,974,640	\$2,753,800
Cumulative Expenditures	\$2,200,000 (Pending final reconciliation/invoice)	\$ 5,407,512.00	\$2,702,724	\$2,268,567
LOE per Contract (Days)	919 (expat) 4068 (LH) (Includes no-cost extension)		2,016	
LOE Utilized	925 (expat) 4200 (LH)		1,915	2333
Key Personnel	Resident Advisors: Frank E. Blimling (2002 – 2003) Bryan D. Stirewalt (2004 – 2005) Senior Policy Advisor: Karen J. Wilson Financial Specialist: Alex Kutsenko Legal Advisor: Gary A. Gegenheimer	Resident Advisors: Frank E. Blimling Larry D. Boren James Satterfield Glenn S. Tasky Senior Policy Advisors: H. Joe Selby Karen J. Wilson Legal Advisor: Gary A. Gegenheimer	Resident Advisors: Alex Barabolak Frank E. Blimling Larry D. Boren Jay S. Doeden James Satterfield Glenn S. Tasky Senior Policy Advisors: H. Joe Selby Karen J. Wilson Legal Advisor Gary A. Gegenheimer	Resident Advisors: Frank E. Blimling Terry L. Stroud Jay S. Doeden Glenn S. Tasky Senior Policy Advisor: H. Joe Selby Legal Advisors: Patrick Parise Ross Kendall